TAX EXEMPTIONS

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Symposium conducted by the

TAX POLICY LEAGUE

December 28-30, 1938

In Detroit, Michigan

POLICY LEAGUE, INC.
309 East 34th Street
NEW YORK CITY

PRINTED IN THE UNITED STATES OF AMERICA
BY J. J. LITTLE AND IVES COMPANY, NEW YORK

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FOREWORD

THE power of tax exemption has potentialities which do not suffer greatly by comparison with the power to tax. It can be used to safeguard and to exploit, to subsidize one interest and destroy another, to simplify administration and to confuse it, and to vitiate a tax or to give it effectiveness.

The problem of tax exemption no doubt had its origin very shortly after taxes were first invented; and it has ramified and multiplied, as taxes have become more numerous and diverse, to perplex legislators, administrators, and taxpayers in devious ways. Each new tax brings pressure for new exemptions as well as for revision of old exemptions. Such pressure may be in the interest of equity or for the promotion of some great social objective, but it is fully as likely to have evasion of civic responsibility as its purpose. An originally equitable tax may be inequitably distorted by later exemptions, while an inequitable tax may be corrected by this process.

At the same time that demands for tax exemptions increase, however, sentiment for their curtailment also gathers force. Public budgetary requirements have become too urgent and expansive to permit the extension of tax exemption favors in the casual manner so often characteristic of the past. Re-evaluation of the merits of certain traditional exemptions is being suggested, as well as thoughtful consideration of alternative methods more appropriate than tax exemption for the encouragement of social and economic progress.

The Tax Policy League, impressed with the need for clarification of the issues inherent in tax exemptions, both

present and prospective, chose this theme as the subject of its third annual symposium. The program was planned, as have been those of previous years, with the purpose of a frank and well balanced examination of the subject in all its major aspects, by a group of distinguished specialists, each one of whom was particularly qualified to develop an important phase or point of view. The opinions and conclusions presented, it should be added, are those of the respective participants and do not necessarily reflect the collective views of the organization.

Any well rounded consideration of the problems of tax exemption must go farther than statistical appraisal of the exemptions with respect to specific taxes. It must make adequate recognition of the nature of the influences and purposes underlying various types of tax exemption and must concern itself with the principles and questions of public policy involved. Tax exemption, in its lowest form, is merely the product of deferment to certain political and economic pressure groups. It is used extensively, however, for the safeguarding of minimum subsistence levels, as well as for the encouragement of certain economic, social and religious activities. It is an important factor in facilitating the efficient administration of taxes, and figures significantly in intergovernmental relations and their incidental exemptions to bondholders and public employees.

The choice of topics and their arrangement in this volume were dictated by a desire to stress the major implications of tax exemption in relation to sound tax policy. The papers have been grouped in five divisions: general theory of tax exemption, subsidy exemptions, intergovernmental exemptions, subsistence and other exemptions, and exemptions to stimulate improvements. While this arrangement is in some respects an arbitrary one, as certain of the papers are designed to give perspective to the subject and many of

them necessarily present material which belongs appropriately under more than one division, it serves the useful purpose of bringing unity and proportion to a subject which has often suffered at the hands of uncoordinated, piecemeal treatment.

The committee in charge of the symposium consisted of James W. Martin and Frank H. Morse, and myself as chairman, with Harold S. Buttenheim and Mabel L. Walker as *ex officio* members.

FREDERICK L. BIRD,
Chairman,
Program Committee

PART ONE

GENERAL THEORY OF TAX EXEMPTION

CHAPTER I

GENERAL THEORY OF TAX EXEMPTION [1]

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THE theory of tax exemptions may be attacked from a number of viewpoints. The approach adopted for purposes of this paper depends on the fact that the several kinds of exemptions are supported by different considerations and that they vary in their impact on the legal, fiscal, economic, political, and administrative phases of social organization.[2] The discussion which follows should be regarded as presenting samples of classes of exemptions, and it should be understood as offering the barest outline of certain theoretical implications of the particular exemptions discussed.

NATURE OF TAX EXEMPTIONS

Perhaps the narrowest general concept of *tax exemption* is that which embraces only subject matter within the purview of a tax law but which is excluded by explicit provision of the statute or constitution. As Professor Shoup suggests, an exclusion of cigar sales from the scope of an excise tax on transactions in manufactured tobacco products

[1] See list of references on theoretical bases of tax exemptions in bibliography, pp. 222-23.

[2] This view is taken by most of the writers whose works are cited in the first section of the bibliography, notably by the Connecticut Committee on Tax Exemptions, Professor Jensen, Mr. Knapp, Dr. Logan, the New York Special Joint Committee, the New York Constitutional Committee, Professor Plehn's Committee, Professor Shoup, and Dr. Stimson.

would be an exemption if the tax were levied on sales of tobacco products with cigar sales expressly eliminated, but an exclusion would not be an exemption if exactly the same tax were imposed by enumerating cigarettes, snuff, and other tobacco products than cigars. This view makes the nature of exemptions depend on the language of the law rather than on the effect of it.[3] Moreover, this idea takes no cognizance of the final resting place of a particular tax.[4]

At the opposite extreme is the definition of exemption in such terms that it means all exclusions from the scope of a tax, whether of persons, property, income, transfers, or transactions. According to this conception, for example, elimination of personalty from the scope of the property tax would be regarded as an exemption, even though the statute simply imposed the tax on realty and did not mention any other class of property. This viewpoint, though tenable from one angle, may lead to absurdities. For instance, should failure to impose an excise on coal production when one is levied on oil production be regarded as an exemption? Is there an exemption if, although a *state* tax is levied on securities, no *local* rates apply?

For purposes of this paper, an intermediate and possibly less adequately defined notion of tax exemption is adopted. The term includes for present purposes all exclusions from the scope of a tax of subject matter—property, persons, transactions, transfers, et cetera—which is logically within the base, without regard to the means by which the exclusion is accomplished.[5] An exemption in this sense, for instance, would be equally an exemption whether a given sub-

[3] Carl Shoup, "Tax Exemption," *Encyclopedia of Social Sciences,* XIV, 528 ff.

[4] It is important that this entire discussion has reference to the operation of particular taxes, not to the operation of the tax system. No definition of exemption can concern itself fully with the final incidence of a tax.

[5] This view seems to be substantially in keeping with that of Cooley, *The Law of Taxation,* sec. 651.

class of transactions be eliminated from a general class otherwise subject to tax by express exemption or by definition of terms so that the major class will no longer include the subclass. For present purposes, too, states and their local subdivisions, rather than the one or the other, are regarded as a unit.[6] A common sense understanding of the term such as this, as distinguished from a scientifically defined conception, is subject to considerable error in certain applications. For example, some gasoline taxes are imposed exclusively on "fuels customarily used and usable in internal combustion engines," and certain fuels are expressly exempted. Other statutes get much the same result by imposing the tax on all petroleum products and certain others but specifically omitting fuel oil commonly used for heating purposes. Is there an exemption of heavy fuel oil in the latter but not in the former case?

It must be understood, too, that the content which is likely to be read into the term "exemption" is confused by variations in its application. Property tax exemptions, for instance, may be determined by the kind of property, by the use to which it is put, by its use *and* the length of time it has been so employed, by the identity of its owner, by the identity of its user, or by the identity of its owner provided it is devoted to specified use—to mention only a few of the complications. In the case of income taxation the situation is just as diverse. Income may be exempt on the basis of who gets it, the use to which it is put, its source, its amount, et cetera. The situation is equally mixed up in the case of excises on transactions or on transfers. In the present sense of the word, of course all these criteria give rise to *bona fide* exemptions.

In the remainder of this discussion, four classes of exemptions are considered briefly. These arise from a desire to

[6] Cooley, *loc. cit.*

protect the minimum of subsistence, to remove the state itself from the purview of taxation, to subsidize agencies and activities which perform a public service even though privately owned, and to encourage certain businesses or other activities deemed desirable.[7]

Exemption to Protect the Minimum of Subsistence [8]

One important class of tax exemption arises from an attempt on the part of legislators to avoid imposition of taxes on the subsistence minimum. If any taxpayer has income or property so small in amount that taxation would tend to constitute the taxpayer a public charge, then the state normally is justified in exempting that income or property from any tax whatever.[9] Exemptions of small amounts of personal property and initial exemptions under income and death taxes are the most common guises in which this class appears.[10]

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[7] One of the most important classes *not* discussed is that which may be designated technical exemptions. Such exclusions from the scope of a tax law are prompted by the fact that the subject is otherwise taxed or by a desire to avoid double taxation. Jensen (*Property Taxation in the United States,* pp. 133 ff.) calls such exemptions "pseudo-exemptions." Cooley (*loc. cit.*) does not consider these exemptions, properly speaking. An illustration is found in the exemption (or pseudo-exemption) of automobiles from the personal property tax if they are subject to some excise in lieu of property tax for convenience of administration. Exemption of mortgages—secured by land—from the intangibles tax may be prompted by a desire to avoid double taxation since the realty is subject to tax.

[8] A. G. Buehler, "Taxation and the Minimum of Subsistence," *American Economic Review,* June, 1933, pp. 234–44.

[9] *See* the searching analysis in Gustav Cassel, "Theory of Progressive Taxation," *Economic Journal,* Dec., 1901, pp. 481 ff.; the Colwyn Committee Report (*Report of the Committee on National Debt and Taxation,* cmd. 2800), pp. 125–136; and F. Y. Edgeworth, "Graduation of Taxes" and "Formulae for Graduating Taxation," *Papers Relating to Political Economy,* II, 243 ff. *Note* also Jensen, *op. cit.,* pp. 155 ff.; H. L. Lutz, *Public Finance,* 3d ed., p. 552; National Industrial Conference Board, *State Income Taxes,* II, 45 ff. and *State and Local Taxation of Property,* pp. 31–32; and C. C. Plehn, *Introduction to Public Finance,* 5th ed., p. 243.

[10] Professor Shoup (*loc. cit.*) appears to disagree with this interpretation, apparently because he has in view the incidence of the *tax system* rather than the operation of the *particular tax.* This class of exemption, as a practical matter, arises from two considerations other than desire for exemption of the subsistence minimum: to offset regressive effects of con-

Exemption of small amounts of tangible personal property from tax levies has a two-fold purpose. In the first place, it prevents the taxpayer who has very little property from being called on to make an excessive contribution, in the light of other taxes he bears, to the support of the state. In the second place, the exemption is designed to simplify administration of the property tax. The implications of the first purpose are clear; possibly the second requires some explanation. In some jurisdictions small amounts of property are not legally subject to tax because listing is regarded as uneconomical. The administrative consequences of such a practice are mixed, some of them operating to introduce economy and some operating to omit from assessment certain property which is legally taxable. In those commonwealths in which there is no exemption the personal property tax laws usually provide for enforcing the state's tax claim against the taxpayer's property. However, it has been found that public officials, whatever the law, are unwilling to levy upon a meager collection of household goods; and, consequently, the tax in practice is not collected from citizens having in the aggregate only $100 or $200 or $300 worth of wealth.[11] Some authorities have urged that an exemption of $200 or $300 is not sufficient to give the taxpayer any material relief and that the exemption serves merely to complicate record-keeping processes and in general to cause trouble.[12] Possibly it is significant that numerous states still maintain this modest provision for the protection of the subsistence minimum which is often regarded also as simplifying administration.

In the case of income and death taxes the characteristic

sumption taxes and to simplify administrative problems. *See* Plehn, *op. cit.*, p. 238.

[11] In Arkansas, for example, inability to secure execution against very small property owners has gone a long way toward demoralization of tax collection machinery.

[12] E. g., *Report of the Kansas Tax Code Commission*, 1929, p. 156.

initial exemptions are more important, as well as more precise, in their general economic and administrative implications. In the United States the form of income tax exemption most frequently found is a fixed amount of income. During the past two or three decades exemptions of this sort have ranged between about \$600 and \$10,000. This type of exemption has been criticized as theoretically unsound, because under a graduated income tax it modifies the tax of a person subject to higher rates to a greater absolute extent than it does that of a person subject to only minimum rates.[13] If the range in rates, for example, is from 1 to 6 per cent and the exemption is \$1,000, the value of the exemption to a person subject to the minimum rate is \$10; the value to a person subject to the maximum rate is \$60. In consequence, this type of exemption, though still the most common, appears to be losing popularity.

A second type of income tax exemption comparable with the first is an exemption not chargeable to the income as a whole but chargeable against the first bracket or brackets of a taxpayer's income.[14] Such an exemption frees the same amount of income from liability to tax; but the value of the exemption is exactly the same to every taxpayer having identical dependents, since in all instances the exemption is charged against that bracket or those brackets of income which in any event would be subject to the minimum rate.

Precisely the same economic result may be obtained by providing that initial exemptions shall be credited against the computed tax rather than against the taxpayer's income.[15] If, for example, the tax is computed on the entire

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[13] For a demonstration *see* *Report of the Wisconsin Tax Commission*, 1928, p. 56. *Consider* the detailed arguments in the Commission's earlier *Report of the Tax Commission in Response to Resolution 8A*, pp. 9 ff.

[14] Personal exemptions under the Kentucky Income Tax Act are thus computed.

[15] This plan is employed, for example, in Arizona, Iowa, and Wisconsin.

net income of every taxpayer, and each person is then relieved of $10 of tax, the money value of the relief to each class of taxpayer is precisely the same whether his income be great or small.

The types of exemptions already discussed are of such character that they apply irrespective of the taxpayer's income or inheritance.[16] Both with respect to income taxes and with respect to death taxes, it is feasible to develop a type of exemption which disappears when the need for it as a protection for the subsistence minimum ceases to be. One such type is abrupt in its operation.[17] The effect of such an exemption disappearance is that at some levels of income or of inheritance, the disappearance of the exemption results in a severe jump in the effective tax rate. For that reason, the Australian Royal Commission recommended, and many other students of taxation have proposed, a method of disappearance substantially similar to that found in the Kentucky inheritance tax law, which provides that as the inheritance increases above a specified amount, the exemption shall be reduced by the number of dollars by which the specified sum is exceeded. For example, it might be provided that under an inheritance tax a widow's exemption amounting to $10,000 would be reduced by the amount which the legacy to the widow exceeded $30,000. If that were done, the exemption would entirely disappear in the case of a widow's legacy amounting to $40,000 or more.

Another type of exemption similar in purpose to the initial income and death tax exemptions is found in certain excises.[18] The most common illustration in the United

[16] The classic example is found in the British income tax.

[17] *Fourth and Final Report of the Royal Commission on Taxation* (Australia), 1934, sec. 1214, p. 202.

[18] On this subject see Haig and Shoup, *The Sales Tax in American States,* p. 87, and Jacoby, *Retail Sales Taxation,* p. 114. The sound-

States is the exemption from general gross sales taxes of food, medicine, and sometimes other related items. The theory on which such exemptions are predicated is that expenditures for the exempted items are essential for the protection of family budgets. Taxation of the necessities of life makes the sales tax especially burdensome on the very poor and in general renders it more regressive than it otherwise would be. This theoretical justification of such exemptions is offset by certain other considerations which need to be weighed in relation to the relief the exemptions provide for the minimum of subsistence. It is particularly important that exemption of specific commodities is likely to wreck the administration of a general sales tax act, which at best is vulnerable from this viewpoint.

Exemptions of Public Property, Income, and Activities

It has generally been accepted as a matter of legal theory that a tax will not be collected from the government itself because administration of such a tax requires the governmental unit to pay a bill to itself.[19] The cost of the transaction may prove substantial, and thereby tend to impair the solvency of the taxing jurisdiction.

A number of specific problems arise in this connection because of the complex character of governmental organization. The property, income, or transactions of any one taxing jurisdiction, if not exempt from taxation as a matter of right, are normally within the taxing jurisdiction of a number of other governmental units.[20] If, for example, property owned by the state be considered, it is immedi-

ness of Jacoby's conclusion (p. 90) that the greater equity from food exemptions more than compensates loss of administrative efficiency may be questioned in the light of recent experience.

[19] The general legal theory is stated in Cooley, *op. cit.*, secs. 604–648 and also in 61 C. J., 359 ff.

[20] The New York State Constitutional Convention Committee, Vol. X. chap. 10, has provided an excellent discussion of this problem. *See* also C. W. Stimson, "Exemption from Property Tax in California."

ately apparent that it is situated ordinarily within the taxing jurisdiction of a county, a township, a city, and oftentimes of other taxing units. Conversely, the city's property is located in such a manner that if not exempt by law it is within the jurisdiction of the state, the county, and frequently other taxing units. (There is a technical exception in the case of a few cities such as Baltimore and the cities of Virginia.)

In the light of these circumstances, a problem arises as to whether one taxing jurisdiction should tax the property, income, or transactions of another. Many writers would seek the answer in terms of whether or not the incidental economic benefits of the public property or activity are greater than the cost to the local taxing jurisdictions of servicing them. A state university, for instance, requires police protection, fire protection, and other local governmental services. In most states, however, the property of such an institution is exempt from municipal taxes. Notwithstanding this exemption, cities throughout the state vie with each other in an effort to secure within their boundaries the location of such a public institution, anticipating that the benefits to be derived from increased trade, expanding property values, etc., would outweigh the loss from the tax rolls of the property on which the university is situated.[21]

Other institutions, particularly those involving disagreeable odors or unsightly buildings, detract from the value of surrounding property, and are consequently much less desirable to the locality in which they are situated. Certain states have attempted to distinguish these two classes of enterprises and to modify the subsidy or eliminate it, de-

[21] *See* George McAneny, C. A. Dykstra, James W. Martin, and Staff (under J. L. Jacobs), *Fiscal Relations between the United States and the District of Columbia*, sec. 11, for discussion of perhaps the most extreme case in the United States.

pending on the character of the institution.[22] In view of the bases on which political action is likely to be predicated, distinctions of this sort are dangerous because the applications made are likely to be erratic. In consequence, most constitutions provide arbitrarily for dealing with the problem.[23]

Such studies as have been prosecuted tend generally to support the view that exemption of public property does not operate to bring about severe local hardships.[24] The showing is not entirely consistent, and it may well be that some local communities suffer material handicaps by virtue of the exemption of federal and state properties and perhaps of the properties of other local taxing jurisdictions. The extent of such hardships, however, is unquestionably minor.[25]

The most serious consequences of the policy of exemption of the property, income, and transactions of governmental units from the levies of other taxing jurisdictions are administrative in character. There is material difficulty in so administering tax laws that exemptions of this or any other class do not cause more loss of revenue from excess costs, and particularly from extra-legal exemptions, than the tax relief amounts to. This problem in respect of property taxes is comparatively simple and is traditionally established in many states. Consequently, the administrative friction

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[22] James W. Martin, "Social Aspects of Tax Exemption," *Annals of the American Academy of Political and Social Science*, January, 1936.

[23] *See* New York State Constitutional Convention Committee, Vol. III, for a convenient source of information.

[24] *See* especially the study by the New York Special Joint Committee on Taxation and Retrenchment, *Tax Exemption in the State of New York*.

[25] This generalization is not perhaps applicable to large-scale public housing, as developed in Europe. It has recently been urged by an eloquent proponent of exemptions to public and quasi-public activities that housing subsidies ought to be made on some basis other than tax exemption. Paul Studenski, "Municipal Subsidies for Public Housing," *National Municipal Review*, December, 1938, pp. 577 ff.

occasioned by property tax exemptions is less than that brought about by income and transactions tax exemptions. Since property taxes are generally taxes *in rem,* and since real property in particular is reasonably easy to classify on the basis of use, the essential difficulties are perhaps less serious than they are in the case of other sorts of taxes.

In respect of income taxes, likewise, there is an element of simplicity if the exemption is applied exclusively to the public agency itself. If it is applied to securities and other evidences of public debt, the administrative problem of drawing the line between exempt and taxable items is greatly increased.

From an administrative angle, the exemption of public transactions from excise taxes involves much greater friction than the exemption of property or income of public enterprises. First of all, statutes providing for such exemptions differ materially as to whether the exemption is provided on sales *to* the taxing jurisdictions, sales *by* the taxing jurisdiction, or both such classes. If exemptions apply to both classes of transactions, then they may be regarded politically as excessive. If they apply only to one or the other, they may be thought inadequate. In actual practice, the facts seem to indicate that the exemption of neither the one nor the other of these classes of transactions will secure the result of relieving the public of tax.[26]

Moreover, the problem is complicated by drawing the line between transactions which are public transactions in the statutory sense and those which are not. Assume, for instance, that sales of motor fuel to the state government are exempt from the gasoline tax. Does it follow that sales of gasoline to highway patrolmen using their own vehicles are exempt? Would such a sale be exempt if the highway

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[26] *Panhandle Oil Co.* v. *Knox,* 277 U. S. 213.

patrolman used a public vehicle but was required to pay his own expenses which were reimbursed on a per diem or combination per diem and mileage basis? In either instance, assuming the exemption is applicable, how can it be administered in view of the fact that the motor fuel tax is collected at the time the gasoline is brought into or produced in the state by the original importer or manufacturer? When such queries as these are applied to general gross sales taxes and to all the various other sorts of excises the problem assumes insoluble proportions.

One of the most difficult theoretical problems relating to tax exemption arises from the doctrine of reciprocal immunity from federal and state taxation under the federal system of government. So far as the United States is concerned, this doctrine was originally developed in the opinion of Mr. Chief Justice Marshall of the Supreme Court of the United States in the case of *McCulloch* v. *Maryland*.[27] The general theoretical issues involved cannot be elaborated in this connection, and in view of the substantial recent literature on the subject [28] do not require such elaboration. A very brief outline of the fundamentals, however, follows.

Should one of two coordinate governments having jurisdiction over the same persons undertake to tax the property, income, and transactions of each other, that might well impair the sovereignty of the government subject to tax. It has been urged that the cogency of this principle is much greater in the case of the property, income, and transactions of the central government than in that of the common-

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[27] 4 Wheat. 113.

[28] *See* especially *Helvering* v. *Gerhardt*, decided by the Supreme Court on May 23, 1938, as well as the literature cited. My own point of view is developed in "State and Local Policy toward Reciprocal Immunity," *Minnesota Municipalities*, Dec. 1938, pp. 416 ff. *See* also chapters by James W. Martin and Robert E. Hatton in *Tax Relations Among Governmental Units*.

wealth.[29] The reason for this is that the central government represents all of the states and that any particular state, therefore, has an opportunity to protect itself through legislation. On the other hand, in the case of the United States, forty-seven states are not represented in any one state legislature, and therefore there is greater danger of discrimination against the federal government through state taxation. In reiterating this latter phase of the legal theory on which federal immunity from state taxation is based, Mr. Justice Stone[30] took occasion to point out that legal principles were much less absolute in character, and practical considerations much more important as a matter of sound legal interpretation, than had been assumed at the time the doctrine of reciprocal immunity was developed. The Justice in reiterating the abstract course of reasoning seeking to justify discrimination against states seems to have overlooked the application of his own precept to the case for legislation by states and their municipalities and subdivisions. The distinction invoked is logically sound but in a practical, political sense substantially meaningless.

Two specific phases of reciprocal tax immunity have far-reaching practical consequences. In the first place, as the doctrine has been applied in the United States, not only the property and income of each jurisdiction in its official governmental capacity are exempt from taxation but also the exemption as construed extends to apply to the debts and the interest on debts, even though the owner of the credit or the recipient of the interest be a private person. One of the most serious impediments to graduated personal income taxation has been the exemption of interest on public securities from taxation. This exemption has not been so considerable in amount as to cause great difficulty, but it has seri-

[29] *Helvering* v. *Gerhardt*. 58 Sup. Ct., 969 (1938).
[30] *Ibid.*

ously impaired the effectiveness of graduated rates as applied to certain income recipients.[31]

The other particular phase of reciprocal immunity which may be singled out for specific comment is the immunity of property, income, and transactions only remotely connected with the performance of the public business.[32] One of the most serious aspects of this problem and one of the least defensible is the exemption of public salaries from income taxation.[33] It is clear that income taxes are designed to tax each individual according to his ability to pay or according to some other criterion of personal taxation. To exempt a large number of incomes on the ground that the source of the income is tax-exempt results in another serious impediment to justice in taxation. The interferences with tax policy are all the more apparent when it is considered that the principle of intergovernmental immunity has been invoked in respect of a number of commercial enterprises merely because they perform certain functions regarded as governmental in character.[34]

In addition to exemption of public and semi-public salaries from income taxation there is also, under a comparatively recent expansion of the doctrine of reciprocal immunity, an exemption of transactions from state excise taxes, even though the transactions are only remotely connected with federal activities.[35] Such exemptions have been provided over the invariable protest of certain members of the bench.

[31] Professor (Under Secretary) Magill in "The Problem of Intergovernmental Exemptions" has suggested a means by which both Congress and the states can avoid most of the difficulty by varying legislation.

[32] *Panhandle Oil Co.* v. *Knox, loc. cit.*

[33] Department of Justice, *Taxation of Government Bondholders and Employees.*

[34] The cases are reviewed in the Department of Justice study above cited.

[35] *Ibid.*

Exemption of Private Agencies and Activities Performing Public Functions

One class of tax exemptions more or less uniformly provided in the United States concerns private agencies performing functions which in the absence of such agencies would have to be undertaken by the public. The most common instance of such private agencies performing public functions is charitable and educational institutions.[36] To some extent health agencies, usually on a charitable basis, are also involved. It is commonly accepted that if, in the absence of a private enterprise, taxation would be necessary in order to discharge a needed function, the state may properly subsidize the institution which performs the service. A common method of subsidy is through tax exemption.

The provision of this type of subsidy through tax exemption involves employment of a very crude measuring stick. It is scarcely to be assumed that if the state made a direct subsidy to educational and charitable institutions it would do so in proportion to the amount of property used by each institution. Indeed, the converse might well be true, at least in certain particular instances.[37] Nevertheless, in the United States this form of subsidy is by far the most usual, although direct subsidy and other classes of indirect subsidies are not unknown.

Another characteristic of this policy is the introduction of all of the administrative problems that characterize exemption of public institutions and agencies as such, and certain others in addition. The difficulty of distinguishing

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[36] Religious organizations' properties and activities are usually regarded by legal writers as falling in this class. Indeed, the word "charitable" is so defined by law in most jurisdictions as to include "religious." This view, though resting on valid historical grounds, is now as a practical matter untenable.

[37] *See* Martin, "Social Aspects of Tax Exemption," *loc. cit.*, for fuller development of this point.

between educational and charitable institutions entitled to the subsidy and those which are not entitled to it is considerably greater than in the case of distinguishing between publicly owned property and privately owned property.

Another class, which is generally construed to involve a subsidy for public activity, is exemption to private housing enterprises designed to make provision for satisfactory living quarters for the poor. Essentially speaking, this variety of subsidy is different from exemptions for other charities only because it involves a larger amount of property. In purpose and in general principle the problem is the same insofar as private housing undertakes to supply service to its clients at less than cost.

Exemptions as a Subsidy to Desirable Enterprise or Activity

Another conception on which tax exemption policies are sometimes based is that of providing encouragement or aid to some particular activity or arrangement which the state regards as desirable. One of the most common exemptions of this variety, which, however, has its origin in a somewhat different set of considerations, is the usual subsidy to religion.[38] Religious activities and properties are regarded as desirable and hence in many jurisdictions are largely, or entirely, tax-exempt. To some extent exemption of religious enterprises and their properties is based on public service considerations, but in the modern state in which freedom of religion obtains this phase of the situation as a practical matter is minor.

A number of other activities, which in some jurisdictions are exempt from taxation, receive the subsidy on grounds similar to those invoked for exemption of churches. Among

[38] *See* footnote No. 36.

these are the organizations of veterans, the Boy Scouts, labor and agricultural organizations, etc.

In the same general class are the homestead exemptions, about which so much has recently been said.[39] Perhaps most of the factors resulting in homestead exemptions are predicated on the general assumption that home ownership is desirable and should be encouraged. It is true, but usually neglected, that the amount of the exemption is inversely proportional to the need for it and that those who have greatest need enjoy no exemption because they own, and can own, no homes. Nevertheless, subsidy of home ownership as a desirable social arrangement has been vigorously argued. Here, as in the case of many other tax exemptions, the theories on which the exemption is originally justified are mixed and often contradictory.

Still another exemption designed to subsidize a desirable activity is illustrated by the provisions in the constitutions and laws of several states that manufacturing property of certain classes, or new manufacturing properties, for a specified period shall be exempt from taxation.[40] It is of interest that the cost of such exemptions is borne in part by economic enterprise already established. Thus, viewed from one standpoint, established business and industry grant a subsidy to induce new competition. In this instance, as in all other cases, the amount of the exemption is not very nicely adjusted to the size of the subsidy which the state would be willing to grant directly; rather it is a crude instru-

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[39] *See* list of references on homestead exemptions in bibliography.

[40] Other illustrative examples of exemptions having similar purposes are exemption of capital in fiber and cotton manufacture, proposed, Arkansas, (National Tax Association *Proceedings,* 1925, p. 28); exemption of cattle, Maine (*ibid.,* 1915, p. 417); exemption of building and loan associations, Maryland (*ibid.,* 1922, p. 22). *See* also Parmoor, "Government Proposals on De-rating," *Contemporary Review,* March, 1929, pp. 282–9; "Tax Exemption for Housing Corporations in New York City," *Monthly Labor Review,* Aug., 1927, p. 291.

ment for aiding new enterprise at the expense, ordinarily, of earlier developed industry and commerce.

In respect of exemptions as subsidies, the legal and administrative problems are substantially similar to those incident to exemptions extended on account of public services performed. However, the friction incident to the administration of subsidy exemptions is normally much greater than that arising from exemption of agencies performing a public service. This fact arises largely from the difficulty of distinguishing the desirable and subsidized activities from others closely related, and also from the definition of the exempted agency or activity. The latter point is particularly well illustrated in the extreme difficulty experienced in administering homestead exemptions in several of the states.

PART TWO

SUBSIDY EXEMPTIONS

CHAPTER II

EXEMPTIONS TO EDUCATIONAL, PHILANTHROPIC AND RELIGIOUS ORGANIZATIONS

LUCY WINSOR KILLOUGH

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THE practice of exempting educational, philanthropic and religious organizations from taxation is widespread. Each layer of government in the United States—federal, state and local—grants such exemptions. The nature of the exemptions and the kinds of taxes from which exemptions are granted vary in the different jurisdictions. The following discussion will concern exemptions of privately owned institutions and organizations, but not exemptions of educational and charitable organizations which are owned by governments.

INCOME TAX EXEMPTIONS

The federal income tax act grants a number of tax favors to organizations "operated exclusively for religious, charitable, scientific, literary, or educational purposes." [1] Individual income taxpayers may deduct from their gross income contributions to such organizations up to 15 per cent of their net income.[2] Corporate income taxpayers are allowed a similar deduction to an amount not exceeding 5 per cent

[1] *Revenue Act of 1938,* sec. 23 (o), (2) and (q); sec. 101 (6).

[2] *Ibid.,* sec. 23 (o). Sec. 120 permits unlimited deduction if such contributions plus certain taxes exceed 90 per cent of net income.

of net income.[3] Both he who gives and he who receives may claim income tax exemptions. It requires eighteen subsections of the federal income tax act to describe the organizations exempt from the corporate income tax.[4] These organizations are varied in nature including, among others, labor organizations, fraternal societies, cemetery companies, and certain farmers' associations. Doubtless most of these organizations could lay claim to a modicum of educational, philanthropic or religious purpose, although they are separately enumerated. The blanket exemption [5] includes a provision that "no substantial part of the activities" of the exempt organization may be for "carrying on propaganda, or otherwise attempting, to influence legislation." Apparently this provision does not apply to the separately enumerated organizations. In respect to most of the exempt organizations the law specifies that no part of their earnings may inure to the benefit of any private shareholder or individual.

The federal income tax act grants an indirect subsidy to religious organizations by exempting "the rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation." [6] Similar exemptions are not granted to the employees of educational and philanthropic organizations.

In those states which have income tax laws the exemptions to educational, philanthropic and religious organizations are, in most cases, similar to those of the federal government. Some of the state laws have copied verbatim the applicable sections of the federal legislation. Thus, educational, religious and philanthropic organizations are exempt from both federal and state income taxation on their

[3] *Ibid.*, sec. 23 (q).
[4] *Ibid.*, sec. 101.
[5] *Revenue Act of 1938*, sec. 101 (6).
[6] *Ibid.*, sec. 22 (6).

own income, and contributors to them are exempt from federal and state income taxes on their contributions.[7] Some states also grant the special exemption to ministers of the gospel.

The federal and most of the state estate and inheritance tax laws exempt bequests to educational, philanthropic and religious organizations. Some of the states limit the exemptions to bequests to organizations within the state.

Property Tax Exemptions

The most frequently discussed type of tax exemption of educational, philanthropic and religious organizations is the customarily granted exemption from property taxation. In a number of states the right to such exemption is granted in the state constitution. In others it is a matter of state law. The states not only deny themselves the right to tax such organizations but also specify that the local governmental units may not tax them. The exemption provisions of laws and constitutions are frequently sweeping in nature. For example, the section of the Massachusetts laws dealing with property tax exemptions contains thirty-five subdivisions,[8] one of which exempts inclusively "Personal property of literary, benevolent, charitable, and scientific institutions and of temperance societies incorporated in the commonwealth, the real estate owned and occupied by them or their officers for the purposes for which they are incorporated . . ."

The general wording of the provisions regarding tax exemption has been responsible for a great deal of litigation in Massachusetts and in other states. The courts have been called upon to decide the meaning of such words as benevo-

[7] Subject to the 15 per cent of net income limitation of the federal statute and similar limitations in most of the states.

[8] *Tercentenary Edition of the General Laws of the Commonwealth of Massachusetts,* 1932, chap. 59, sec. 5.

lent, charitable, and literary and to decide when property was being used for purposes which would render it tax-exempt. Are farm lands owned and operated by educational institutions to supply food for students properly exempt? What is the status of dwelling houses occupied by members of the faculty and administration? Where the law is vague on these points and municipalities have endeavored to tax the doubtful property, the courts have been called upon to interpret the laws.[9]

The possibilities for battles of figures over these tax exemptions are limited by scarcity of information. That the total value of tax-exempt privately owned property in many states amounts to impressive millions is well known. There are, however, no standards of valuation for churches and colleges. In some states assessors are required to value tax-exempt property, but such valuations are frequently nominal. An indication of the size of the problem is given in figures compiled by the Tax Commissioner of Connecticut.[10] In 1933 the total value of privately owned tax-exempt property in the five states, Connecticut, Massachusetts, New Jersey, New York and Rhode Island, was estimated at $2,887,362,864. This was 29.6 per cent of all tax-exempt property in these states.

With the exception of Connecticut, the value of publicly owned tax-exempt property in each state materially exceeded the value of privately owned exempt property. The percentage of all exempt to all taxable property ranged for these states from 14.6 per cent in Rhode Island to 24.5 per cent in New York. There appears to be great variation

[9] For a summary of Massachusetts court decisions on such points see *Exemption from Taxation in Massachusetts,* Printed for the Colleges and Universities of the Commonwealth, Boston, 1910.

[10] Connecticut, Pub. Doc. No. 52, Taxation Doc. No. 265, *Quadrennial Statement by the Tax Commissioner of Real Estate Exempted From Taxation,* Hartford, March, 1935, pp. 7 and 8.

among the states in the importance of tax-exempt property. Figures for fifteen widely scattered states in 1921–1923 indicated that the ratio of all exempt to all taxable property varied from 1 per cent in Idaho and 1.2 per cent in Arizona to 19.4 per cent in Washington and 21.7 per cent in New York.[11]

The amount of exemptions granted under federal and state income taxes and death taxes might be determined more accurately than the value of property tax exemptions. Presumably the major part of contributions and bequests are deducted from the taxpayers' returns. One indication of the size of these deductions is the contributions listed on federal income tax returns. Total contributions of over half a billion dollars were claimed in each of the years 1923, 1924, 1927, 1928 and 1929. These represented slightly over two per cent of declared net incomes. For the thirteen-year period 1922–1934 the largest percentage of net income contributed to exempt organizations was 2.61 per cent in 1932. Because of the low level of incomes in that year this amounted to only $304,000,000.[12]

Detailed enumeration of the laws and mores of tax exemptions are hardly in place in a paper intended to bring out discussion and evaluation of the principles of such exemptions. Similar principles apply to exemptions from different types of taxes by federal, state, and local jurisdictions, although many different problems of administration are involved and proposed changes would require different types of action.

Much of the discussion of the subject has been more

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[11] National Industrial Conference Board, *Tax Burdens and Tax Exemptions,* New York, 1923, p. 63. The states included were Ariz., Conn., Ida., Ky., La., Mass., Minn., Nev., N. J., N. Y., Pa., R. I., S. D., Wash., and Wyo.

[12] United States Treasury, Bureau of Internal Revenue, *Statistics of Income, 1934,* Part I, pp. 27 and 28.

fervent than reasoned. A spokesman for the colleges of Massachusetts described local attempts to tax college dwelling houses by stating that the "municipalities *attacked* the colleges . . ."[13] Former President Eliot of Harvard referred to the "*barbarous* character of the proposition to tax property devoted to educational purposes."[14] One writer emphasizes the necessity of preventing "houses of worship from being desecrated and secularized by taxation."[15] In answer another voice states that it "detracts from the glory and independence of true religion to be a pauper and a leech upon the State."[16] In town and gown controversies over tax exemption the leech characterization from town spokesmen is familiar. In a recent Cambridge-Harvard argument the president of the city council stated, "They (Harvard) are willing to accept everything and give nothing. All the use we are to them is to remove their ashes and garbage and give them police protection on Saturday afternoons at football games."[17] Public evaluation of tax exemption policy too often depends upon the relative skill of exempt organizations and tax proponents in devising convincing epithets. On the one side are barbarous, desecrating attacks and on the other paupers and leeches who accept everything and give nothing.

Reasons for Exemption

What are the reasons for exempting privately owned educational, philanthropic and religious organizations from taxation? In general these exemptions are based on the

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[13] *Exemption from Taxation in Massachusetts,* p. 12, italics mine.

[14] *Ibid.,* p. 43, italics mine.

[15] General Dix's *Letter on the Taxation of Churches,* dated New York, March 7, 1876, publisher not given, unpaged, pamphlet.

[16] Westbrook, Richard B., *A Few Plain Words Regarding Church Taxation,* pamphlet, printed for the American Secular Union by J. B. Lippincott Co., Philadelphia, 1891, p. 8.

[17] *Boston Herald,* October 19, 1938.

assumption that the exempted organizations are performing services of such value to the public that they should not be called upon to contribute to the public treasury. These services appear to be of two different kinds, although such a distinction is not usually made by those supporting exemptions. One group of services includes all those which it would be necessary for the state to perform if they were not being performed by private organizations. The other group consists of socially desirable but less necessary services which would not be supplied at all if it were not for the private organizations.

Obviously it is impossible to decide in the case of many individual services whether they fall in one or the other category. It is evident in the United States, however, that many educational services which are supplied in some regions by privately endowed institutions are supplied by state-supported institutions in parts of the country where the endowed institutions are too small and too few to supply the need. Recent experience has shown also that much of the welfare work of private charities is taken over by governments when private funds prove inadequate. At the other extreme are religious organizations. In a nation with separation of church and state the purely religious functions of the church would not be supplied if private organizations did not exist. The distinction is an important one because the reasons for tax exemptions are different for each group.

Let us consider first the reasons for exempting from taxation private organizations which are supplying services which the state would be called upon to supply if it were not for the private organizations. If private schools, colleges, and charitable institutions were taxed, their services and benefactions would be cut down by the amount of their taxes. Then if the state were to take over some of the functions which these institutions have had to give up be-

cause of taxation, there would be no net gain to the community. Money would simply have been put into one pocket and taken out of another. There would even be a net loss to the community if it is true, as tax exemption proponents frequently argue, that private institutions are more efficiently managed than public ones.

So far the argument has assumed that taxation would cut down the amount of service rendered by educational and charitable institutions and that, if taxed, they would continue to function but on a somewhat lesser scale. It is frequently implied, however, that private benefactions would cease if it were not for tax exemptions of contributions to and of the property of these private organizations. Tax exemption is cited as a necessary incentive to private giving, and taxation called a menace to philanthropy. For those who believe that taxation would mark the beginning of the end of privately supported education and charity the justification of exemption is complete. If taxation were to make it necessary for government to supply not only those services formerly rendered with funds not collected in taxes, but also to supply many services formerly rendered through private gifts, governmental costs would increase by an amount materially greater than the new tax collections. It follows from this line of reasoning that the community receives a net profit from tax exemption which is the difference between the total value of the services of the tax-exempt organizations and the cost, in foregone taxes, of the exemption.[18] It has been estimated, for example, that private hospitals in New York State perform services worth $20,837,564, that if taxed these hospitals would pay $3,748,405

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[18] For an analysis on these lines see Tobin, Charles J., Hannan, William E., and Tolman, Leland L., *The Exemption from Taxation of Privately Owned Real Property Used for Religious, Charitable and Educational Purposes in New York State*, 100 State Street, Albany, 1934, Part III.

and that, therefore, the profit to the state is the difference between these two figures or $17,089,159.[19]

The second category of exemptions includes those to religious and other organizations which perform services not likely to be thought of as state functions, although commonly held to be socially desirable. The reasons usually given for these exemptions are more general in nature and somewhat less concerned with dollars and cents. Tax exemption of church property is defended on the ground that religious organizations promote morality and thus further the welfare of the state. It is said that without the influence of religion "the whole framework of our civilization would be severely threatened," [20] and that "religion and morality are essential . . . to the very existence of the organic state." [21]

Spokesmen for tax-exempt organizations have often claimed that their organizations are performing more socially valuable services with the money they do not pay in taxes than the government would perform if it were to collect the taxes. One writer's view of the relative desirability of religious and governmental expenditures runs as follows:

> As we believe that the state atmosphere is purer, that politics are cleaner, that all human life is more healthful, that the rich are richer and the poor less poor, and that everywhere human conscience is in all ways more free, because of the presence of these charitable and enlightening institutions of religion and morality—let us refuse to expose these institutions to the risk of being squandered and ruined by state extravagance or thrown into the common grab-bag for the plundering of municipal rings.[22]

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[19] *Ibid.*, pp. 51–53.
[20] Tobin, *et al.*, *op. cit.*, p. 21.
[21] Brown, T. Edwin, *Some Reasons for the Exemption of Church Property from Taxation*, pamphlet, Scranton, Wetmore and Co., Rochester, 1881, p. 12.
[22] *Ibid.*, p. 48.

The classic statement of this doctrine was made by President Eliot in 1874:

> To tax lands, buildings, or funds which have been devoted to religious or educational purposes, would be to divert money from the highest public use,—the promotion of learning and virtue,—to some lower public use, like the maintenance of roads, prisons, or courts.[23]

There are a number of lesser arguments for tax exemptions which are brought forward whenever they seem appropriate. Churches, colleges and schools are frequently housed in edifices which improve the general appearance of the community. This not only increases the level of beauty and culture but also raises land values in the vicinity. Thus the community may make up revenue lost in tax exemption by increased tax returns from other property. Obviously this argument is not to be advanced when the buildings are not beautiful or in the case of insane asylums or other institutions which may detract from the desirability of a locality. Communities are also said to benefit by the buying power of the employees and students of educational institutions. These arguments are largely responsible for leading tax exemption proponents to the conclusion that the exemptions cost nothing. There is, for example, no conclusive evidence that tax rates are higher in those communities which have large amounts of tax-exempt property than they are in similar communities with less tax-exempt property. Comparisons of this sort are not very significant, however, because of the difficulties in finding truly similar communities with and without large exempt institutions as well as because of the generally unsatisfactory nature of tax rate comparisons.

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[23] *Exemption from Taxation in Massachusetts, op. cit.,* p. 23. The strength of this belief at the present time is testified to by Knapp, Farwell, "Tax Exemptions," *Proceedings* of the 27th National Conference of the National Tax Association, 1934, p. 74.

Validity of Reasons Given

To what extent can the student of taxation accept these reasons for exempting educational, philanthropic and religious institutions from taxation? The committee which arranged this program and other tax economists have classified such exemptions as subsidy exemptions. If it is to be generally accepted that these tax exemptions are subsidies, the problem resolves itself into two parts. First, is it desirable to subsidize these organizations? If the answer is "no," the question is disposed of; if "yes," we are faced with the second question. Is the present method of indirect subsidization by tax exemption superior to the possible alternative of direct subsidization by grants from the public treasury?

There can be no reasonable unqualified answer to either of these questions. There are, however, a number of non-profit religious, semi-educational or semi-charitable institutions which are now tax-exempt to which the community would not be willing to make direct grants. These may well be considered first. Purely religious organizations are the outstanding example; some other probable cases are temperance societies, fraternal organizations and agricultural societies. Unless all exemptions of educational, charitable and religious organizations are to be regarded as inviolable this latter group merits first and most doubting examination.

The present writer finds it difficult to justify exemptions to organizations whose functions the state would be unwilling to support by direct grant. It can hardly be regarded as axiomatic that all expenditures by these groups are for "higher public uses" than those of the state. Who knows whether the increase in public morality due to a stained glass window is more or less desirable than the community benefits of a new snow plow? If the promotion

of morality is ground for tax exemption, it might be wise to exempt the home. Certainly many public service enterprises, banks, and individuals erect buildings which contribute to an increase in property values in their vicinity. It is difficult to see why a beautiful residence or bank or railroad station should be regarded as evidence of increased taxpaying ability on the part of its owner, while a beautiful church should be exempted because it adds to beauty, culture, and land values.

Undoubtedly many existing exemptions could not legally be removed, and sudden removal of others would work undue hardship. There are a number of changes which might be made to prevent further accumulation of exempt organizations. Wherever there are constitutional provisions that broad categories of institutions must be perpetually tax-exempt these provisions should be repealed. The recent ratification by the voters of New York State of the constitutional amendment "freezing" the present exemptions is to be regretted. The people should have the right to change their views by legislation as conditions change. New additions to the tax-exempt group should be carefully examined and when it is evident that their proposed functions are not generally accepted as government functions the exemptions should not be granted.

In a recent Rhode Island report it was suggested that all now enjoying exemptions should be required to appear before a legislative committee or commission and show cause why their exemption should not be repealed.[24] Some such provision for occasional or periodic checking on the functions performed by tax-exempt organizations seems highly desirable. Whenever an exemption is removed the removal should be gradual. That there will be great differences of

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[24] Rhode Island, *Report of the Commission on Ways and Means,* made to the Governor, November 27, 1935, Providence, p. 38.

opinion in respect to which functions merit government support is obvious. Different answers will seem correct in different jurisdictions and at different times. The same kinds of questions are answered constantly in this country by democratic processes whenever decisions are made on matters of government expenditures. It is especially important that the way be left open for changing answers applicable to changing conditions. The long run aim should be the abolition of exemptions to organizations which would not be directly supported by government.

When we come to the educational and charitable organizations which perform services for which the state probably would make direct grants, the problem is more complex. One difficulty arises from the varied nature of the services performed by these exempt institutions. Some of the services would be generally accepted as worthy of government support and others would not. A state or city might willingly grant funds for college classrooms and laboratories and at the same time refuse support to stadia, luxurious dormitories, and fraternity houses. Yet in many jurisdictions tax exemptions apply to all alike. A logical division suggests itself here. Governments might tax those parts of private charitable and educational institutions which the governments would not be willing to support, and exempt or directly subsidize the remainder. The practical difficulties of such a plan would be great, but some more study of it might well be made before deciding that the difficulties are insurmountable. The difficulties may be no greater than those involved in justifying the present situation in cities which harbor tax-exempt near-mansions occupied by college undergraduates and taxable slum tenements. Obviously the suggestion that some of the more luxurious aspects of educational and philanthropic institutions might be taxed does

not imply that they should be eliminated, but merely that they should contribute to the public treasury.

Finally, there are those privately performed services which are generally accepted as public responsibilities. Here there are various possible alternatives. The present method of indirect subsidy by tax exemption might be continued. Or it might be better for all taxes levied by all governmental jurisdictions to apply without discrimination to educational, charitable and religious organizations, and then for the different governments to make direct grants to such institutions to be used for services which are to be given public support. This would result in an increase in government control as the grants would necessarily be contingent upon the performance of certain services. This leads to the third alternative which many profess to believe would be the inevitable outcome of public grants—namely, complete government ownership and operation of philanthropic and educational institutions. A possible fourth alternative would be the full taxation of all philanthropic and educational institutions unaccompanied by any subsidies whatever. This would go farthest in relieving the institutions from public control. If enough people wanted them badly enough to pay for them such organizations might exist side by side with publicly operated ones. In fact, they do so exist today in such forms as private schools and sanatoria operated for profit in the same jurisdictions as public schools and hospitals.

Control of Exemptions

The aspect of the present method [25] which is most in need of modification concerns the problem of control. If an institution falls within a category generally accepted as edu-

[25] The present situation with many different jurisdictions granting varied exemptions from all sorts of taxes is a single "method" only in that there is indirect subsidization with relatively little control.

cational, benevolent, literary, charitable, or whatever fits into a particular legally accepted vocabulary, it is automatically exempted from taxation by constitutional or legislative requirement. There is no way of effectively considering the question as to whether the community or the tax-exempt organization would make best use of the money not paid in taxes at a particular time. The mildest reform would provide for periodic evaluations of the status of even the most deserving recipients of exemption. Similarly no additions should be made to the tax-exempt list without careful evaluation, if, in fact, they should be made at all. These minor changes would require constitutional amendment in many states and the repealing of existing and enactment of new legislation by others and by the federal government. Educational institutions can scarcely uphold their status as bulwarks of democracy if they are unwilling to subject their efforts to this small measure of democratic control.

This is probably too half-hearted a measure. It might be better if all individuals and institutions paid taxes without exemptions for any contribution to, or expenditure for, however charitable or educational a purpose. When the indirect subsidies had been disposed of in this way the question of direct grants should be considered. In response to a plea for exemptions from a group of hospitals the special California Tax Commission of 1929 stated:

> It is the feeling of the Commission that the exemptions should be curtailed, rather than extended, but it also realizes the extreme difficulty of bringing about such a contraction. With respect to the plea of the hospitals, to which it has given sympathetic study, it has concluded that, while it cannot recommend any expansion of the exemption list, it does desire to record its conviction that recognition should be given to the public importance of the work of certain of these institutions through more liberal public grants and payments where activities

of these institutions clearly have the effect of caring for cases which otherwise would be a charge on the public funds.[26]

This recommendation might well be heeded by other states and applied not only to hospitals but also to other organizations.

There are a number of advantages in direct grants. They provide for continuous evaluation of the merits of particular projects. They might be made by more appropriate jurisdictions than frequently happens at present with many communities granting enormous indirect subsidies to institutions largely used by people from other regions. Direct grants would make evident the real financial relationship between the institutions and the community. Direct grants might be a simpler way of distinguishing between functions entitled to public support and those not so entitled than an attempt partially to tax and partially to exempt institutions performing such mixed functions. It seems to the writer that these advantages outweigh the disadvantages many of which have been suggested in the foregoing pages.

There is little reason to believe that any such great change in present practice is probable in the near future. The difficulties involved are emotional as well as legal and financial. The first step should be the prevention of increases in the exemptions, to be followed as far as possible by their gradual elimination.

[26] *Final Report of the California Tax Commission,* Sacramento, 1929, p. 90.

CHAPTER III

LURING INDUSTRY THROUGH TAX EXEMPTION

KENNETH J. MCCARREN
Vice-President, Detroit Board of Assessors

FOR years students of taxation have been campaigning for the adoption of uniform tax laws throughout the nation. Common sense dictates that economic stability cannot be obtained until tax conflicts are eliminated, and the tax burden is levied on a fair and equitable basis. Yet, regardless of this sound advice, the legislatures and electorates of some states have enacted tax exemption laws that further complicate the national tax structure, and some cities close their eyes to constitutional and statutory requirements, and grant tax exemption in whole or in part to certain industrial property.

The states complain about encroachments by the federal government and protest against its infringement on states' rights. But, at the same time, there is a continuous economic war among states, and among taxing districts within states. Each is struggling for economic supremacy, but at the same time weakening its own economic structure, as well as that of others.

There is no complaint against states that offer natural inducements to attract industry. Subsidies in the form of tax exemptions, however, are in violation of the first principles of a sound tax program. Today, they affect the states and local units that are endeavoring to levy taxes on a fair

basis, but if the competition increases and other states are forced to offer grants and subsidies, it is hard to predict what the result will be.

The practice of certain communities in offering an industry local tax exemption over a stated period as an inducement to locate its operations in that community, is one that on the surface offers that industry a lift on the road to prosperity.

At the same time, on the surface, it offers the community a lift toward its goal as an industrial metropolis. After we have scrutinized the fallacies that lie beneath this bright appearing surface, its economic weakness becomes apparent, and the whole unsound proposition becomes indeed, another gift horse. If the industry must consider as a basis of its future prosperity the shirking of a cardinal duty—its equitable share of the cost of government—it seems that its house is built on the sands, and its owners will be better advised to invest their money in some other line of endeavor.

If the community is so lacking in attractions that it must violate sound principles of taxation, or its own tax laws, in order to attract new industries, it will be better advised to maintain undisturbed its existing status, for it cannot hope permanently to keep up the competitive pace with other communities possessing these attractions. It is axiomatic that disregard of natural economic laws leads ultimately, but, nonetheless surely, to economic chaos, and this applies to governmental units as well as to private enterprises. The old adage, that when you dance you must pay the fiddler, is still true.

Instances are indeed rare in which taxpaying industries already located in a given place subscribe to the inducement of tax exemption to prospective new industries. The reasons why taxpaying industries are inherently cool toward

the idea of tax exemption to a newcomer are obvious to any fair-minded person. Is it a manifestation of human nature to consent graciously to a proposition to place one's neighbor on a more favorable basis than one's self, bearing in mind that the same law governs both, and is enforced against one and not against the other?

Let us assume that the new industry coming in free of taxes is a competitor of an industry in the community, or in the state, that is paying taxes in accordance with the law. How many of you would consent to the violation of the law, or to a law which enabled a competitor to undersell you, and at the same time enjoy the same per dollar profit? Would you agree to narrowing the tax base, and contribute to make good the other fellow's obligation to the support of governmental services? The answers to the foregoing questions are so obvious that the questions carry their own answers. I submit that the real beneficiaries of attracting and relocating industries are the professional secretaries of commercial bodies, and public officials who are motivated by ideas of self-glorification.

Reasons for Industrial Relocation

Some industries have been induced to move to other communities, but there were other reasons more attractive than tax exemption. The cooperative survey of the Civic Development Committee of the National Electric Light Association and the Policyholders Service Bureau of the Metropolitan Life Insurance Company refute the claim that tax subsidies are the most important attraction:

> It is significant that bonuses, free taxes, free land or free buildings, which inducements at one time were offered, and still are, from time to time, did not appear among the three reasons most frequently advanced for the selection of a location of a plant.
>
> The ranking of reasons for all gains for the United States as a whole is shown by the following list:

1. Markets
2. Labor
3. Transportation
4. Materials
5. Available factory buildings
6. Personal reasons
7. Power—fuel
8. Cheap rent
9. Near related industries
10. Living conditions
11. Financial aid
12. TAXES

Following taxes in twelfth position are:

13. Mergers
14. Cheap land
15. Near parent company
16. Banking facilities

The report of the committee studying the personal property tax and its effect on removal from New Jersey of various concerns, listed the reasons in the following order of importance.

1. Greater convenience and economy
2. Consolidation, bankruptcy, dissolved
3. Labor difficulties
4. Taxation
5. Zoning ordinances
6. License increase (Hoboken)
7. The Art and Philosophy of Government in Washington, D. C.

George A. Steiner of the Department of Economics of the University of Illinois, in his study of *The Tax System and Industrial Development,* concluded:

> There is no question that industries might move from one state to another if the tax differential were sufficiently large. This would be particularly true of marginal firms located in unfavorable sections. But, in the nine states selected for this study, the tax differentials would not be large enough to favor industrial relocation.
>
> The implication is, that shifts in industrial location that may have occurred in the years covered by this study were caused by factors other than variations in tax burdens.

The nine states included in Mr. Steiner's study were, Illinois, Indiana, Massachusetts, Michigan, Minnesota, New York, Ohio, Pennsylvania and Wisconsin.

Some southern states are now carrying on elaborate campaigns to attract industry, tax subsidies being among the attractions, but not the most important.

The president of a Detroit industry received the following letter from the Southern Engineers, who evidently are attempting to specialize in the relocation of industries:

SOUTHERN ENGINEERS
NATCHEZ, MISSISSIPPI

May 12, 1938

Attention: the President

Gentlemen:

A number of fine progressive Southern cities with populations of eight to twenty-five thousand are extremely anxious to secure desirable industries.

These cities will give liberal financial cooperation in order to obtain desirable industries; the financial cooperation to be used entirely for fixed assets.

The following advantages can be found in many of these cities: Lowest cost power and fuel, liberal tax exemptions, low prevailing taxes, political administrations that are in full accord with industry, competitive water freight rates, convenience to many raw materials, *and a labor supply from Anglo-Saxon stock that is almost impossible to agitate.*[1]

These communities will cooperate in carrying out such features as will practically insure contented workmen so that the Head of the industry need not come to his place of business in the mornings filled with apprehension of what his labor will do.

Should you be interested, we shall be glad to give you definite information pertaining to such communities as may be adapted for your industry, and we want you to feel free to ask for any information or service, for it will be given without obligation, as we do not take fees from industries.

(*Signed*) SOUTHERN ENGINEERS
E. G. PFAHL

Supposed Benefits to Industry

This letter may sound attractive to some industrialist, but let us analyze it to find what the present and future benefits may be:

[1] Italics mine.

1. The industry may benefit at the beginning by financial cooperation. If it is an outright grant some one must foot the bill which means shifting the tax burden. If financed by a bond issue, the industry may find itself paying its own bill, as well as that of other industries at the expiration of the exemption period.
2. "Low cost fuel and power." This ranks as the seventh most important reason in the survey of the Joint Committee previously quoted.
3. "Liberal tax exemptions and low prevailing taxes." The growth of cities from industrial expansion requires the expenditure of tax revenue for necessary public improvements. Therefore, there is no certainty that the present tax level can be maintained.
4. "Political administrations that are in full accord with industries." But who, today, can guarantee who will be the administrators tomorrow and what their political philosophy may be.
5. "Competitive water freight rates." This advantage depends entirely upon the industry's market, and is usable but a few months of the year.
6. "Convenience to many raw materials." This is an advantage and ranks fourth in importance in the committee's survey.
7. "A labor supply from Anglo-Saxon stock that is almost impossible to agitate." Well, you can draw your own conclusions about that attraction. I suppose it is a polite way of telling the Detroit industrialist that labor will work cheap and continue to work cheap. But, industrialists have learned that busy plants go hand in hand with purchasing power. The prosperity that we have enjoyed in the North resulted from living wages and ability to purchase the products of industry.

Thomas L. Stokes, reporter and investigator for the Scripps-Howard newspapers, was sent into the South to investigate the consequences of the migration of industry. He told us that while tax subsidies were an inducement, the main attraction to most industries was cheap labor. After discussing his findings with economists, Mr. Stokes reports: "Economists, interested in replenishing of mass purchasing power, look askance not alone for their failure to pay decent wages to their own workers, but because of their effect in driving down wage standards generally."

Real Benefits to Community

In the above, we have looked only at one side of the picture, the supposed benefits to the industry. This is only of minor importance to us. Naturally, our major concern is as to the real benefits to the community.

Right at this point, I should like to interject my doubt concerning a belief widely held and frequently expressed in the advertising literature of chambers of commerce and organizations of similar character. Such literature seems to assume as a fact, that the addition of any industry to any community is always an asset. It is my belief that the addition of industries on many occasions results in a distinct liability to the community in which they locate.

Unfortunately, there does not seem to have been developed a technique for measuring the benefits or losses resulting from the location of new industries in a given community. In fairness to the people living in any community and who collectively compose that community, however, no attempt should be made to bring in new industries with their benefits and burdens until and unless a very serious objective study has been made of the probable effects.

It is a notorious fact that some southern states have gone

in for wholesale tax exemptions, and others have refused to levy taxes to take care of local needs, consequently, the federal government has been required to shoulder almost their entire relief burden. Thus the taxpaying industries of other states, in addition to meeting their local tax obligations, must pay through federal taxes the cost of relief for those who have refused to meet their own responsibility.

Constitutional Provisions for Uniformity

Many state constitutions provide for a uniform rule of taxation, and all provide that similar property be taxed uniformly. In other words, if the property of a given industry is subject to taxation by operation of the local or state tax law, the property of company "A" on First Avenue must be taxed the same as the property of company "B" on Second Avenue. When duly authorized public officials assume the duties of their office, they subscribe to an oath to uphold the constitution and statutes of the state whose office they have been appointed or elected to fill. When these same officials become a part of a campaign to bring new industries into their local governmental unit, and, as an inducement offer these enterprises illegal tax exemptions over a stated period, it is obvious that they deliberately violate their oath of office, and hold for naught the constitution which they have sworn to uphold.[2]

These same officials would wax exceedingly wroth, if one would, in cold blood, offer them a bribe to assist in the violation of a given statute, yet, they blithely go on their way offering enterprise a bribe by way of tax exemption in violation of law. In principle, is there any difference between these two forms of bribery?

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[2] A number of states have enacted laws or constitutional amendments requiring or permitting temporary exemption of newly constructed plants. Some cities, however, offer and grant illegal exemption.

I submit, that tax exemption as the price of securing a new industry in any given locality is in conflict with all accepted principles of sound taxation. But, the most serious aspect of these subsidies rests in the fact that there is no logical end. The granting of subsidies by one community eventually impels other communities to grant similar or larger subsidies, almost as measures of self-protection. Such a policy, if continued over a long enough period of time, should logically end in complete exemption of all industrial enterprises, with disastrous effects on our whole national economy.

PART THREE

INTERGOVERNMENTAL EXEMPTIONS

CHAPTER IV

DISTRIBUTION OF TAX-EXEMPT SECURITIES

CARL H. CHATTERS

Executive Director, Municipal Finance Officers' Association

THE threat to tax the income from federal, state and municipal securities by new legislation or constitutional amendment has aroused speculation concerning the ownership and outstanding volume of securities previously held to be exempt from federal income taxes. Such data are not readily available, either as to the amount of the debt or the holders thereof.

VOLUME OF TAX-EXEMPT SECURITIES

As of June 30, 1937, the total outstanding debt of the United States government, other federal agencies, and state and local governments amounted to $65,502,000,000. Of this amount the direct debt of the United States government was $35,803,000,000, of federal agencies $10,547,000,000, and of state and local governments $19,152,000,000. The obligations of the state and local governments are generally exempt from federal income taxes, while $29,057,000,000 of the debt of the federal government and its agencies is partially exempt.[1]

OWNERSHIP OF STATE AND MUNICIPAL BONDS

Reference to Table I indicates an attempt to show the ownership of state and municipal bonds outstanding on

[1] United States Treasury Department, *Securities Exempt from the Federal Income Tax as of June 30, 1937.*

TABLE I

OWNERSHIP OF STATE AND MUNICIPAL BONDS [a]

Outstanding June 30, 1937
(*In Thousands of Dollars*)

All are exempt from the federal income tax
(Estimates by Carl H. Chatters)

Life insurance companies	$2,234,123	
Fire and marine insurance companies	186,126	
Stock casualty companies	128,959	
Total Insurance Companies		$2,549,208
Commercial banks (13,795)	2,567,801	
Mutual savings banks (550)	534,333	
Total banks		3,102,134
Fraternal benefit societies		700,000
Federal, state and local agencies		
U. S. Government, federal trust funds & agencies	528,000	
State and local sinking funds	1,491,000	
State and local trust & investment funds	2,279,000	
Total governmental agencies		4,298,000
Individuals		
With net incomes in excess of $5,000	3,500,000	
With net incomes less than $5,000	700,000	
Estates, trusts & partnerships not included in above	500,000	
Total individuals		4,700,000
Non-finance corporations		400,000
Unaccounted for—Foreign bondholders, educational institutions, endowment funds & all other classes not listed		3,402,658
Total state and local debt		$19,152,000

[a] The data in this table are partly estimates. Sources are *Securities Exempt from the Federal Income Tax as of June 30, 1937*, U. S. Treasury Dept. 1938; *Assets and Liabilities of Operated Insured Banks*, as of Dec. 31, 1937 by the F.D.I.C., 1938; the manuals of the Spectator Co., Best's Insurance Reports, Annual Reports of the Controller of the Currency, and extensive correspondence.

June 30, 1937. This shows that the biggest group of holders of state and municipal bonds are individuals, although in the aggregate they hold only $4,700,000,000, or 24.54 per cent of the total. The next largest group consists of federal, state and local agencies, which own $4,298,000,000, or 22.44 per cent. The third group of holders consists of the banks, both commercial and mutual savings, which own in the aggregate $3,102,134,000, or 16.19 per cent. The insurance companies of all kinds owned $2,549,208,000, or 13.31 per cent.

Other large groups are the fraternal benefit societies owning approximately $700,000,000, and non-finance corporations with holdings of $400,000,000. This still leaves unaccounted for a total of $3,402,658,000, or 17.76 per cent of the bonds, which must include foreign bondholders, educational institutions, endowment funds, and many other classes. It also includes large amounts which undoubtedly should have been listed with some of the above classes. The figures given in Table I are taken in part from the report of the Treasury Department on tax-exempt securities, from reports of the Federal Deposit Insurance Corporation, the insurance manuals published by the Spectator Company and Best's, as well as reports of the Controller of the Currency. Some of the data on which to base estimates came from correspondence.

Ownership of Federal Securities

The ownership of securities of the United States government and federal agencies is more difficult to trace. Undoubtedly the banks hold a far greater percentage of the federal than of the state and local debt. In other words, they own $16,069,350,000 of federal debt, constituting 34.66 per cent of the total. The next largest holdings are those of various federal, state and local agencies, which own

TABLE II

SECURITIES OF THE UNITED STATES GOVERNMENT AND FEDERAL AGENCIES [a]

Their Tax Status and Ownership

As of June 30, 1937
(*In Thousands of Dollars*)

Amount		
Total federal debt—direct and guaranteed		$46,350,000
Tax Status		
United States Government securities		
Wholly exempt	$15,065,000	
Partially exempt	20,738,000	
Securities of federal agencies		
Wholly exempt	2,228,000	
Partially exempt	8,319,000	
		$46,350,000
Ownership		
U. S. Government, federal trust funds and agencies	8,015,000	
Federal Reserve Banks	2,526,000	
State and local sinking funds	61,000	
State and local trust and investment funds	200,000	
Held by government agencies		$10,802,000
Life insurance companies	5,200,000	
Other insurance companies	835,000	
		6,035,000
Commercial banks (13,795)	13,669,350	
Mutual savings banks	2,400,000	
		16,069,350
Fraternal benefit societies		50,000
Foundations		64,000
Non-finance corporations		2,500,000
Individuals		
With net incomes in excess of $5,000	2,500,000	
With net incomes under $5,000	850,000	
Estates, trusts & partnerships not included above	400,000	
		3,750,000
Unaccounted for—Foreign bondholders, educational institutions, and all other classes not listed		7,079,650
Total securities of U. S. Government and federal agencies		$46,350,000

[a] Data in this table are primarily from *Securities Exempt from the Federal Income Tax as of June 30, 1937,* U. S. Treasury Dept., 1938. They have been adjusted where it seemed reasonable to do so.

$10,802,000,000, or 23.30 per cent of the bonds. The insurance companies constitute the third largest group of holders of federal securities, owning $6,035,000,000, or 13.02 per cent. It is estimated that individuals, estates, trusts, and partnerships own approximately $3,750,000,000, or only 8.9 per cent of the federal debt, whereas this same group owns 24.54 per cent of state and local bonds outstanding. The non-finance corporations appear to own $2,500,000,000 of federal securities, although this figure is probably far too low. Such corporations may own as much as $5,000,000,000 of the debt. The fraternal benefit societies and the educational foundations have minor holdings of the federal debt, the former possessing approximately $50,000,000 and the latter $64,000,000. Such a distribution would leave unaccounted for more than $7,000,000,000 of the federal debt, which is owned by foreign bondholders, educational institutions, and many other classes not specified above.

The part that federal, state, and local securities play in the holdings within various groups may also be enlightening. As of December 31, 1938, it is estimated that 49 legal reserve life insurance companies with total admitted assets of $25,450,000,000 have invested 17.9 per cent of these assets in United States government bonds and 5.8 per cent in state and local securities. In 1929 only 2.0 per cent were in governments and 3.4 per cent in state and municipal bonds. Thus the increase has been both absolute and relative. The 13,795 insured commercial banks in the United States on December 31, 1937, had 25.2 per cent of their assets in governments and 4.6 per cent in state and local securities, making a total of 29.8 per cent invested in various public securities. The fraternal insurance companies lean heavily on state and local securities for investment, owning perhaps 10 times as many of the state and local securities as federal securities. The holdings of non-finance corporations are

difficult to determine and constitute a relatively small portion of the investments or assets of such companies. It is clear that individuals, estates, trusts, and partnerships cannot possibly own more than 25 per cent of the gross debt outstanding in the name of all governments in the country.

A study has been made of the assets of 1,090 estates probated in Massachusetts between December 1, 1931, and November 30, 1934.[2] It demonstrates that the larger the estate the larger the percentage of state and local securities found in it. This was true, but to a far less degree, with respect to the holdings of these estates in federal government bonds. The smaller estates, that is from \$100,000 to \$249,000, had investments of 1.9 per cent in local securities and 2.1 per cent in federal securities, whereas the estates of \$5,000,000 and over had holdings of 20.2 per cent in local government bonds and 4.7 per cent in federal bonds. The holdings of local government bonds increased progressively with the size of the estate from 1.9 per cent to 20.2 per cent, while the holdings of federal securities increased from 2.1 per cent to 4.7 per cent, with most of the increase attained before the estates reached \$1,000,000. It may be significant to those who question the increased holdings of state and local securities which I have assigned to individuals, to know that these 1,090 estates in Massachusetts alone held more than \$55,000,000 in state and local securities.

All of these figures pertaining to the distribution and ownership of state, local and federal securities are given merely as a background for the discussion of intergovernmental exemptions. They are subject, of course, to many changes and revisions, although they are complete enough to be significant.

[2] Eugene E. Oakes, "The Liquidity of Large Estates in Massachusetts: 1932–1934," *Bulletin of the National Tax Association,* June, 1938.

CHAPTER V

INVESTMENT BANKING AND INTER-GOVERNMENTAL EXEMPTIONS

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Lehman Brothers, New York

Attempts to remove the present exemption from federal taxation on the income derived from state, municipal and quasi-municipal securities have been periodic. The problem, therefore, is not entirely new. Careful research into the matter would probably show that such attempts have been coincident with the need of the federal government for increased revenues. The President has again brought the matter before the Congress in a message in which he advocated the removal of tax exemption from municipal securities, and it is generally understood that some Congressional action will be taken in furtherance of this recommendation. At the present time it is also understood that the administration is contemplating legislation to remove the exemption from federal taxation from the salaries of state and local governmental employees. The present discussion, however, will be confined to the first proposition—that of removing the present tax exemption from state and municipal obligations.

At the outset, it should be admitted that the burden is on those who would remove the present immunity from present federal income taxation now enjoyed by municipal securities, to proceed in an orderly manner to give the people of

the country an opportunity for full and free discussion of this question. The matter becomes of paramount importance, not alone because of the fact that it would afford increased revenue to the national government, but because it involves necessarily the revocation of certain precedents which are practically as old as the United States, and which have been established and reaffirmed in a long line of Supreme Court decisions. I refer to such doctrines as the limitations on the powers of the federal government, especially those providing for strict limitation of the powers of that government to tax the states or their agencies, and the further doctrine of state sovereignty.

Statutory vs. Constitutional Removal of Exemptions

There are those who will say that a simple statute will suffice to enact this fundamental change. I shall not attempt to outline the difficulties to be found in the drafting of such a statute. This practical question, however, arises at the outset. Should such a statute be made retroactive or should it apply only to future issues? It is admitted that the Supreme Court, regardless of its make-up at the time the statute was before it, would have less difficulty in sustaining it if the statute applied only to future issues of municipal bonds. If the statute were drafted in this form and upheld by the Court, there are those who say that the federal government will then be in a position to argue before the Court that in reliance upon this decision the government has power to tax all outstanding securities and thus to accomplish by indirection what conceivably could not have been accomplished by a more direct statutory procedure. For this reason, among others, the Investment Bankers Association at its convention in October, 1938, adopted a resolution favoring the removal of tax exemption from future issues by constitutional amendment and opposing at

the same time the enactment of any statute dealing with that question. Incidentally, since 1920 the Investment Bankers Association has been on record in this matter.

At the present time, because of the agitation over this question, it would not be an exaggeration to state that certain leading firms in the business of underwriting municipal and quasi-municipal securities are finding it a matter of great difficulty to compete at all for certain types of business because they have been advised by counsel to banking houses that there is a doubt as to the tax-exempt status of revenue bonds, including those of authorities, those which are not the obligations of political subdivisions, or those of municipalities payable from special funds. Nor would it be inaccurate to say that at the present time investment bankers and dealers appear to be divided into two groups: those who are following the opinions on tax exemption given by municipal bond counsel who are retained by the issuing bodies, and those who are following the opinions of banking house counsel, among whom the present doubt as to the tax-exempt status of these bonds seems to be more general.

I would not attempt to pass judgment on the relative merits of the position taken by opposing counsel in this matter. Suffice to say that all are extremely able and conscientious to the last degree in protecting the interests, as they appear to them, of their respective clients. From an examination of the positions taken, these facts stand out clearly: (1) At the present time there is no law which holds these bonds to be taxable, and (2) in the case of *Helvering* v. *Gerhardt*, which involved the taxation of salaries of certain employees of The Port of New York Authority and which is so strongly relied upon by those holding the doubtful view, the Supreme Court did not pass upon the question

of the taxation of the income from Port Authority Bonds. Furthermore, it is admitted by some that representations made in advertisements and prospectuses by investment bankers and dealers that these bonds are now tax-exempt under the Constitution as now in force, would result in liability for suits for rescission of contract so remote as to be negligible. These differences of opinion have, of course, been very helpful to those who have been attempting to find ways and means of continuing to offer certain of these securities as tax-exempt during recent months.

Retroactive Taxation

In considering the possible adverse effects on business involved if the statutory method were followed, it is believed in the light of the foregoing, that the method of constitutional amendment is the more desirable. It is further believed that future issues alone should be subject to taxation. No less an authority than Professor Roswell Magill, former Under Secretary of the Treasury, has stated that he did not "desire tax exemption ended on securities now in existence." This is the only common sense view of the situation that can be taken, for these securities were bought and sold on the express representation that they were tax-exempt and both the price paid and the yield to the purchaser were based on that representation. To repudiate this pledge would go far in destroying the faith of the investor in all publicly issued securities and could go a long way towards impairing the credit of the national government itself. It is axiomatic that without confidence capital goes into hiding.

From the standpoint of the investment banker a retroactive tax measure would result in abnormally depressing prices during the necessarily protracted period of liquidation which would result from investors, subject to taxation, dis-

posing of low-yield or high-grade bonds and thus increasing materially the available supply.

In short, the entire problem becomes one which should be approached only from the objective standpoint and above all, should not be allowed to become bogged in a morass of politics in which expediency rather than reason might well be the deciding factor. The advantages of removal should be carefully weighed. If, for instance, it is conceded that outstanding issues are to continue to be exempt, it is obvious that the return to the federal government from the taxation of new issues will be disappointingly small for some years to come. If reciprocal taxation is granted to the states, there will likewise be a comparable return to them, which must be considered.

Again, it has been argued that municipal bonds are bought by the rich primarily to avoid income tax payments. However, the recent study of the Treasury Department made by the Division of Research and Statistics in August, 1938, indicated that of the $19,000,000,000 state, local and territorial tax-exempt securities outstanding, about 25 per cent are governmentally owned. From the breakdown of holdings furnished in this study it is possible to estimate that about 50 per cent of these securities are held by the public in the hands of corporations and institutions to whom tax exemption means nothing; the remainder, or approximately 25 per cent, being owned by individuals subject to surtax. This fact should be noted if we are discussing the elimination of this privilege; for to the majority of holders, if the above percentages are at all accurate, this so-called privilege means nothing. That the existence, however, of the privilege is proving to be a stumbling block in the working out of a more equitable system of taxation must be admitted.

Fiscal Results of Removing Exemption

Whatever method is followed, one thing is certain: state and local governments will be forced to absorb the loss of tax exemption in an increased cost of borrowing, which in turn will be reflected in the interest rates to be paid by them. Real property may again be forced to bear an additional tax burden. This increase will fall more heavily on our local units of governments than on the states themselves, for they borrow in far greater proportions than do the states, in that they supply a more diversified class of services. With the trend definitely towards the financing of services such as water, electricity, housing and transportation by means of revenue bonds—supported solely from the earnings of these enterprises—higher costs of financing may well force the curtailment of many of these services, especially in the case of the marginal borrowers. In those localities which are subject to over-all tax limits, operating costs will become an increasing problem. To many localities, therefore, any increase in interest costs will constitute a serious question which may necessitate the reallocation of amounts appropriated for operating purposes, even assuming that the present easy money policy continues for some time to come.

Many who are engaged in the underwriting of municipal securities have felt for a long time that too much emphasis has been placed on the tax-exempt feature of municipal bonds. They are confident that if, as, and when tax exemption is removed from municipal bonds, they will still prove attractive investments because of the inherent security behind them. The recent depression proved an acid test and the results showed the basic soundness of these securities; it is estimated that less than $1/10$ of 1 per cent resulted in a permanent loss to any investor. Assuming, then,

that tax exemption is removed in the future, a comparison with the best corporate bonds will be welcomed.

Furthermore, if tax exemption is worth anywhere from ½ of 1 per cent to ¼ of 1 per cent—various estimates have been made—it is not difficult to anticipate corporate buyers coming into the municipal market in the future if tax exemption were removed, especially if municipal yields become more attractive to them. This should apply equally as well to individual investors. There is need, however, for a broad educational program designed to familiarize the investor with the fundamental reasons for the inherent soundness of municipal obligations. This implies an improvement in the technique of municipal accounting practices as well as a full disclosure by municipal officials in the statements furnished to the investing public descriptive of the factors upon which municipal credit depends.

Conclusion

To sum it all up, then, we are all primarily interested in the evolution of a sounder tax system and a proper coordination of the relative spheres of federal and state taxation. The question as to whether tax exemption shall continue, should be considered as a part of the broader picture and it should be determined only in accordance with the solution of the basic problem. To rush headlong into the question of tax exemption without careful study of the results to be attained and to attempt through rulings of the Bureau of Internal Revenue to isolate certain quasi-municipal bonds from their present tax-exempt status can only lead to confusion worse confounded in the underwriting business, and an uncertainty in the mind of the investing public that might well tend to unsettle further the capital market.

If tax exemption is to be removed, let it be removed by orderly and systematic procedure through the adoption of

an amendment to the Constitution. The history of recent constitutional amendments shows that they are capable of enactment within a reasonable time, and possibly within the time required for the Supreme Court to pass on a statute removing tax exemption. During the period of ratification there would be afforded time for a real study of the question and an opportunity for the public, both officeholders and citizens, to become acquainted with the issue. Certainly this question, involving as it does a surrender of the states and their agencies to the jurisdiction of the taxing power of the federal government, merits serious and reasoned consideration. Nor can its corollaries themselves be lightly dismissed. There are those who see in any such proposal, be it by amendment or statute, an attempt to destroy the federal form of government and to relegate the states to positions of mere geographical subdivisions with complete national control over the finances of the states and their subdivisions. Such a viewpoint, when expressed by responsible leaders of public opinion, cannot be ignored.

Finally, such removal, if undertaken, should apply equally to all classes of bonds now enjoying tax exemption. There should be no discrimination as to tax exemption between bonds of the City of Detroit, payable from unlimited taxes, bonds of the City of Utica, payable solely from the revenues of its waterworks system, bonds of the City of Knoxville, payable from the earnings of its electric system, and bonds of the New York City Parkway Authority, payable solely from tolls of the Henry Hudson Bridge. It is further believed that any such amendment should likewise preserve to both the federal government and to the states their respective sovereign powers and furthermore, should not make it impossible for the generations to come, in the event of the necessity for borrowing in times of war or domestic stress, again to grant tax exemption, in order to make such borrowing attractive to investors.

CHAPTER VI

INTERGOVERNMENTAL EXEMPTIONS FROM THE FEDERAL POINT OF VIEW [1]

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"INTERGOVERNMENTAL exemptions" is a term covering a very great deal of ground, only a small part of which will be discussed in this paper. On certain aspects of intergovernmental exemptions a federal point of view has not as yet crystallized. A case in point is the immunity of federal property from state and local property taxation. While such property is exempt, Congress has in some cases waived immunity or provided payments in lieu of taxes, but no uniform policy has been adopted. With regard to the exemption of income received from government by private persons, however, a fairly uniform viewpoint has been held by federal administrations for some time. Such exemptions have been condemned by Republican and Democratic presidents and by successive secretaries of the Treasury. President Roosevelt in his message to Congress of April 25, 1938, stated the position in the following language:

> I . . . recommend to the Congress that effective action be promptly taken to terminate these tax exemptions for the future. . . . Such legislation can, I believe, be enacted by a short and simple statute. It would subject all future state and local bonds to existing federal taxes; and it would confer similar powers on states in relation to future federal issues. At the same time, such a statute would subject state and

[1] It should be emphasized that the writer is expressing only his personal analyses and conclusions and that this paper is in no sense an official pronouncement of any governmental agency.

local employees to existing federal income taxes; and confer on the states the equivalent power to tax the salaries of federal employees. The ending of tax exemption, be it of government securities or of government salaries, is a matter, not of politics but of principle.

It is to the question of the exemption of income derived from governmental securities and salaries that this paper will be devoted. The present situation may be briefly stated. The federal government taxes the salaries of the officers and employees of itself and its agencies, with the exception of certain federal judges, and it may issue its obligations with interest fully taxable, partly taxable, or tax-exempt. The interest on the majority of federal securities is exempt from the flat rate normal tax but subject to the progressive surtax. States and localities are not restricted by federal constitutional interpretation from taxing the interest from their own securities or those of other states nor from taxing salaries paid by state and local governments.

It has been believed heretofore that the states and localities could not tax the interest of federal bonds or salaries and that the federal government could not tax the interest on state and local securities or the salaries of state and local officers and employees engaged in essential governmental functions. The federal income tax statutes definitely exempt state and local bond interest, and while it does not exempt state and local salaries the only attempts to apply the law to such salaries have been in the "proprietary" aspects of state and local government. Recent cases have encouraged federal administrators to believe that the taxation of state and local salaries and of interest on state and local bonds would be upheld by the Supreme Court.[2] This is a legal question into which this paper will not enter.

[2] See *Taxation of Government Bondholders and Employees*, Department of Justice (1938).

Inequity of Exemption

An important reason, and perhaps the principal one, for eliminating the exemption is the inequity that arises from the combination of a progressive income tax with a source of tax-exempt income. Persons with large incomes are in a position to gain a great deal more from tax exemption than are persons with small incomes. The operation of the progressive income tax rates is thereby nullified and an especially privileged group of persons is established. The burden of paying the revenues that they escape falls on others. In effect persons with large incomes are offered a subsidy which varies among income levels. The value of the subsidy afforded by tax-exempt securities to individuals at different income levels is shown in the following table.

GROSS ANNUAL YIELD REQUIRED ON A TAXABLE SECURITY BY A MARRIED MAN WITH NO CHILDREN OR OTHER DEPENDENTS, TO PROVIDE THE SAME NET YIELD AFTER FEDERAL INCOME TAXES AS ON A WHOLLY TAX-EXEMPT SECURITY AT VARIOUS YIELDS, FOR SELECTED CASES

NET INCOME FROM OTHER SOURCES	YIELD ON TAX-EXEMPT SECURITY, PER CENT				
	1	2	3	4	5
$ 5,000	1.04	2.08	3.12	4.16	5.20
10,000	1.10	2.20	3.30	4.40	5.50
20,000	1.18	2.36	3.54	4.72	5.90
50,000	1.45	2.90	4.35	5.80	7.25
100,000	2.44	4.88	7.32	9.76	12.20
500,000	3.57	7.14	10.71	14.28	17.85
1,000,000	4.17	8.34	12.51	16.68	20.85

Treasury Department, Division of Research & Statistics

The inequity arising from the exemption of governmental salaries from progressive surtaxes is minor, since relatively few governmental employees have large incomes from other sources which enable them to benefit in a special way from the exemption of their governmental salary. More important is the question whether in fixing governmental

salaries in relation to private salaries the tax differential has been fully allowed for, and the answer to this question probably varies from situation to situation.

Effect of Exemption on Investments

Another important reason for eliminating tax exemption on interest from governmental securities is the disturbing effect that exemption has on the normal flow of investments. Governmental securities have certain qualities of safety and usually of liquidity that make them particularly attractive to persons of small means and to institutional investors. Neither of these groups is much concerned with tax exemption. The inclusion of tax exemption introduces an entirely different factor having no relationship to the inherent qualities of the securities and makes them attractive to other groups of persons and concerns, especially to individuals with large incomes. The result is to divert the investments of wealthy persons who are in a position to take industrial risks into a class of securities which, although practically riskless, rival in net return after taxes the yields of successful speculative securities. The elimination of tax-exempt securities is likely to have a substantial effect on the investment practices of those in the higher income brackets, returning them to the market for industrial securities—an important consideration, especially at the present time.

Revenue Aspects of Exemption

Although they have often received emphasis, the revenue aspects of tax exemption are of distinctly smaller importance than aspects of equity and effects on the capital markets. They are not without significance, however. It has often been pointed out that the savings to government

as a whole through reduced interest rates on tax-exempt securities are less than the loss of revenue from income taxation. Persons who do buy tax-exempt securities because of the exemption feature secure as high an interest rate as they can, and so long as persons in the highest income brackets do not constitute a sufficiently large market to purchase all available tax-exempt securities, the differential in interest rates between taxable and tax-exempt securities will be less than the loss in tax revenues.

It should be observed that the revenue to be derived from the taxation of future issues of securities would begin at zero and would rise slowly. It has been estimated that at present rates of taxation the annual revenue would not reach as much as $100,000,000 before 1954 and that the eventual federal revenue from present exempt securities would be about $250,000,000 annually, assuming that the present securities are replaced by others without change in the total amount outstanding. No estimates have been noted of the probable increase in revenue to state governments.

Federal revenue from state and local salaries would be of small magnitude, being estimated at only about $16,000,000, or an average effective rate of less than ½ of 1 per cent of total state and local payrolls. A large majority of state and local employees would not be subject to the federal tax at all at present levels of personal exemptions.

Costs to State and Local Governments of Eliminating Exemptions in Securities

The reasons for bringing tax exemption to an end seem logically so compelling that many people have thought that if only the constitutional obstacle could be removed the elimination of exemptions would follow as a matter of course. However, the President's recommendation of last

April has been followed by a number of objections. These have centered primarily around the costs of the elimination of exemptions to state and local governments. To a somewhat lesser extent objections have been raised regarding the possible danger to state and local governments due to the fact that "the power to tax is the power to destroy," and regarding the method of making interest and salaries taxable.

The reasoning underlying the belief that states and localities would have their costs raised is that they would gain less in taxes than their interest costs would be increased. Localities do not impose income taxes and cannot well do so. Accordingly there would be no offset for any increases experienced in interest costs, unless state aids were paid or some other state action taken. To a lesser extent the states are in a similar situation. State income tax rates do not reach as high levels as federal rates, and a number of states do not impose income taxes. On the other hand, the substantially larger volume of federal than of state and local securities outstanding gives states an opportunity to gain considerable revenue. Furthermore, a number of states have very little debt outstanding and are not likely to borrow large amounts because of constitutional restrictions and for other reasons. On balance, some state governments would probably gain, while others would lose.

The possible higher costs to states and localities that may result are to be regretted. The matter is not as serious as it might be, however, and for three reasons: (1) the amount involved is less than has sometimes been thought, (2) the imposition of such higher costs is not necessarily inequitable, and (3) if it is found desirable to offset such additional cost in some manner, it can be done without retaining tax exemption.

Various studies of interest rates on corporation securities and on tax-exempt governmental securities appear to show that the variation in interest rates attributable to tax exemption is from 1/4 to about 1/2 of 1 per cent, which is relatively a much smaller fraction of total interest cost than the possible tax savings previously indicated. It does not necessarily follow, of course, that if there were no tax exemption the interest rate would be increased by precisely 1/4 or 1/2 of 1 per cent. A substantial portion of the market for tax-exempts would be eliminated and the tapping of a substitute market might require the payment of an interest rate that was higher than the indicated differential. There appears to be reason to believe, however, that the market for governmental securities of good grade would be easily widened with a small increase in interest. Many persons with smaller incomes could probably be drawn into the market for governments if the interest rates were any higher. In the case of little known units of government, the tax-exempt feature has probably had the effect of widening the market for the securities by making it worthwhile for investment services to analyze the securities and bring them to the attention of wealthy individuals seeking them for investment, however, many local securities are purchased by local people for reasons of civic pride without reference to market conditions.

Costs to State and Local Governments of Eliminating Exemptions on Salaries

A somewhat similar cost situation exists in the case of tax-exempt salaries. Localities could not gain and would suffer from whatever increase in salaries resulted. The state governments, with a relatively small volume of salaries,

would appear to stand to gain more from taxing federal officers and employees than they might lose in higher salaries, and indeed might gain more than the federal government, although the lack of uniformity in state income tax rates, and inadequate information concerning the distribution of salaries make definite statements hazardous. As previously indicated, the amounts of revenue involved are comparatively small.

Perhaps a word should be said for the governmental employee whose salary has been fixed with reference to the tax exemption differential and who might suffer a considerable delay in having it adjusted when exemption was eliminated. It is difficult to say whether tax differentials have been taken into consideration in fixing government salaries, and in adjusting them as income tax rates have changed. Undoubtedly many individuals in choosing to enter state and local governmental service have taken them into consideration. However, the quantitative importance of the tax involved at present exemptions and rates would be of little moment to the majority of government employees.

The fact that local governments would lose financially by the abolition of tax exemptions and that state governments might also lose, although to a lesser extent, does not necessarily imply that such a result, regrettable as it may be, would be inequitable. The differentially low interest rates that states and localities have enjoyed due to tax exemption are a direct result of the existence of high federal income tax rates. Thus it appears that states and localities have been receiving a hidden subsidy from the federal government. Likewise, differentially lower state and local salaries due to tax exemption represent a federal subsidy arising from the income tax. It is unfortunate when a subsidy that one has received for a long time is removed, but its re-

moval is not necessarily inequitable. It would, indeed, appear to be sound policy to bring the hidden subsidy into the open. If the subsidy by the federal government is necessary due to the burdens on local and state governments in comparison with their resources, it could be considered on its own merits and made as an appropriation without the harm done by tax exemption. Some misgivings may be entertained whether the volume of debt incurred in the future by a governmental unit is a sound basis for subsidy, but if it is, tax exemption seems a rough and largely uncontrollable method of providing the subsidy.

Expressions of fear that income taxation would hamper the operation of government by subjecting states or the federal government to destructive taxation have not been frequent in recent newspaper stories. There would indeed seem to be little if any reason for such a fear. Income taxes are imposed not on governments but on private persons. They would not be discriminatory since they would apply with equal severity to private incomes from other sources. It is difficult to see how such a tax would prevent the performance of any governmental function. As Mr. Justice Stone put it in delivering the opinion of the court in the Port of New York Authority case:

> A non-discriminatory tax laid on their net income, in common with that of all other members of the community, could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken, or to obstruct it more than like private enterprises are obstructed by our taxing system. Even though, to some unascertainable extent, the tax deprives the states of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as states.[3]

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[3] *Helvering* v. *Gerhardt,* 58 Sup. Ct. 969 (1938).

Statute or Constitutional Amendment?

Another type of objection has been raised to the method proposed by the President to secure the elimination of tax exemption, namely, that of passing a simple statute. Some persons contend that a constitutional amendment should be employed instead. Some of these persons may merely be trying to delay or block the change entirely, but others undoubtedly believe that the Supreme Court should not be encouraged to make constitutional changes. There is, of course, a long history of such changes, which have taken place at many different times in the nation's history. A number of changes have been made during the past few years. There is no language in the Constitution creating intergovernmental exemptions. Such exemptions were granted by Supreme Court interpretation to meet what were deemed to be the needs of the times. Changing times bring changing attitudes and needs, and if there is reason to believe, as a study of the cases indicates, that the Supreme Court may be willing to approve legislation imposing taxes on governmental salaries and on income from future issues of governmental securities, there would appear to be no harm in passing a law to provide such taxation.[4]

In conclusion, it should again be emphasized that the case against tax exemption rests not primarily on the question of revenue but on equity and economic effects. It would appear that the interests of the national public as a whole are on the side of eliminating tax-exempt income, and that whatever financial adjustments need to be made to meet hardships growing out of the change may be made without standing in the way of this change.

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[4] *Taxation of Government Bondholders and Employees,* p. 84.

CHAPTER VII

SOME CONSIDERATIONS OF POLITICS AND EQUITY WITH RESPECT TO INTERGOVERNMENTAL IMMUNITY[1]

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POLITICS and equity cover a multitude of considerations—and one might say of sins—in this field as elsewhere. The first often operates to frustrate logic and paralyze action. The second is as often appealed to by protagonists on both sides of the question of abolishing the present constitutional-legislative-judicial (and primarily judicial) contours of immunity. Any discussion can add little that is new to the arguments or viewpoints that have been advanced—and more or less passionately debated—many times during the past half century.

But politics and equity are involved in what—if any thing—will be done about a question in which logic has been held to be all on one side[2] and the issue one of com-

[1] Since this paper was written, the House of Representatives has passed a measure (February 9, 1939) providing for taxation of all government workers. See note at end of this chapter for an analysis of the bill.

[2] See nearly all the discussions of the problem, among others, Bennett, E. L., "Immunities from the Income Tax," *Tax Magazine,* April, 1938; Magill, Roswell, "The Problem of Intergovernmental Tax Exemption," *Tax Magazine,* December, 1937; Hatton, R. E., "Reciprocal Immunities of Federal and State Instrumentalities" in *Tax Relations Among Governmental Units;* Brabson, George D., "Income Tax Exemptions and the Loss of Federal Revenue," *Tax Magazine,* January, 1937; Patch, B. W., "Exemptions from Income Taxation," *Editorial Research Reports* (1937), 455 ff.; U. S. Department of Justice, *Taxation of Government Bondholders and Employees: The Immunity Rule and the Sixteenth Amendment.*

mon sense against judicial traditionalism. While the New York Port Authority decision [3] seems to have substantially modified, and perhaps clarified, previous judicial reasoning, the ghost of "politics" still walks the stage of the debate over tax immunity, and the equities involved in the question have not been entirely settled.

The Politics of Tax Immunity

The basic issue of politics is, perhaps, whether a change in the present principles of interpretation regarding tax immunity can be achieved by legislation or whether a constitutional amendment is necessary to that end. It may be said at once that there can be no final answer to that question—until the experiment of legislation is tried. President Roosevelt apparently believes that it needs only a "short and simple statute" to accomplish the end desired.[4] But it will remain for the Supreme Court to determine, first, whether the procedure of legislation is adequate to the purpose, and, second, whether the legislation enacted by the Congress is a proper definition of the new principle sought to be established.

It happens that this raises one of the most interesting questions in the whole field of constitutional law—or, more properly, judicial review. The elaboration of the present doctrine of tax immunity has been almost entirely a matter of judicial interpretation. The Constitution is silent on the subject; the doctrine, first enunciated in *McCulloch* v. *Maryland*,[5] has been distilled from the implications of the theory of federalism underlying our dual system of govern-

[3] *Helvering* v. *Gerhardt*, 58 Sup. Ct. 969 (1938). For an acute discussion of the legal problems involved in this question, see Weintraub, Ruth G., *Government Corporations and State Law*.

[4] *Message to Congress* of April 28, 1938, cited in Chapter VI of this volume; *Message to Congress*, January 19, 1939, *N. Y. Times* (January 20, 1939), 2:3.

[5] 4 Wheat. 316, 4 L. Ed. 579 (1819).

ment. The Supreme Court has extracted from arguments drawn from early conceptions of the nature and operation of the federal system what it considered its inescapable implications—and applied them to later and different conditions. Without imputing any "political" motivation to the Court's decisions in such cases as *Collector* v. *Day*[6] or *Evans* v. *Gore*[7] the present inconsistency and confusion within the frontiers of the doctrine, and, indeed, the very sanctity with which it is hedged, derive largely from its judicial origin and elaboration.

Two points emerge. First, is the doctrine of tax immunity outside the competence of the Congress to define? Is the judicial imprimatur which it has received a guarantee against legislative reinterpretation? Second, if not, is it possible to draft a statute that will rectify the doctrine in such a way as to receive the Court's approval?

On the first question, it is important to emphasize again that there is no "rule" in the whole range of constitutional law which is so completely a product of judicial interpretation. Both the Congress and the executive branch have consistently framed tax policy and its application in deference to the successive refinements which the Court has given to the doctrine. Despite frequent legislative and executive criticisms of the rule and consistent arguments from successive administrations, both Democratic and Republican, for its abolition, no bill for that purpose has passed both houses of Congress, and tax statutes have made only incidental modifications of complete immunity.[8] Treasury officials have fulminated against the rule—and perforce have applied it without any substantial experi-

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[6] 11 Wall. 113, 20 L. Ed. 122 (1871).

[7] 253 U. S. 245, 40 S. Ct. 550, 64 L. Ed. 887 (1920).

[8] For a review of previous legislative and administrative attempts to modify or abolish the rule, see articles cited in note 1. For an example of the Congressional viewpoint, see 68:1, H. Report 30 (1924).

ments in whittling it away by administrative interpretations.

It is perhaps the antiquity of the rule of tax immunity, rather than any explicit constitutional prescription, which explains its present sacrosanct acceptance. The Sixteenth Amendment itself was a product of judicial interpretation of what is a "direct tax." What the Court decreed on that question, and not even with the consistency or the longevity with which the rule of intergovernmental tax immunity has been applied by it, became in effect a barrier to congressional action. The difficult path of amendment became, in fact, the only way out of an impasse on tax policy.[9] And, as has been pointed out, the applications of the tax-immunity rule by the Court subsequent to the amendment's ratification suggests the vigor of a judicial rule once it has been enunciated and long adhered to.

Does this antiquity of the rule preclude its legislative change? Judicial interpretation is, of course, only one of the informal ways of amending the constitution—in effect, if not in fact. But it is the most resilient; since the Supreme Court has "the last say," its practical veto on legislation can be cancelled only by formal amendment. The answer to the first question seems to turn, therefore, on an analysis of the second.

What, then, are the chances of framing "a short and simple statute" on the question which will receive judicial approval? The doctrine has stood for over a century; it has received much elaboration at the hands of the Court;

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[9] It is worth noting that the phrase in the amendment, "from whatever source derived," has been consistently ignored by the Court, and has not so far been utilized by Congress to justify legislation. Perhaps, if explicit constitutional sanction for legislative action in this field is necessary, it will be found by Congress—and the Court—in these words. Such a "formula" would avoid the necessity of overruling a long line of decisions which, in certain areas of federal and state governmental action, seem to be still operative against any universal rule of non-immunity.

it is at present being subjected to much criticism and considerable modification from the Court itself, as well as from administrative officials, tax authorities, and the general public, expert and lay.[10] The Court has, during the past decade, been confronted by an increasing array of more or less farfetched claims to immunity from federal taxation from quasi-employees of state and local governments and from corporations with only a remote relation to the national government.[11] Probably the best explanation of its changing attitude toward the whole problem lies in this fact; it is certainly true that today the temper of the Court on the question is quite different from what it was even a decade ago. It is this change of front—on the broad philosophy as well as on specific instances of tax immunity—that is the best guarantee that a statutory modification of the rule, even its complete abolition, would receive judicial approval. Whether by a short and simple, or a more elaborate, definition of the extent and character of immunity or non-immunity, legislation and not amendment appears not only a feasible but a sensible procedure to attempt. Unless such a statute involved substantial inequities (for instance, *ex post facto* imposition of taxes on outstanding issues, or discriminatory application of non-immunity as between different categories of persons or property, or non-reciprocity vis-à-vis the states), there is no reason to believe that the Supreme Court, as at present constituted, would not find it constitutional. The politics of the constitutional phase of the problem of tax immunity seems to have been solved—within the Court itself—by the logic of a changing pattern

[10] See, for instance, Pegler, Westbrook, "Fair Enough," *N. Y. World-Telegram* (January 6, 1939), 21:1; Minnesota Taxpayers Association, "Double Tax Standard Deplored: No Income Tax for Public Employees," 4 *Taxation* (No. 4, November, 1937), 1. The National Tax Association had a standing committee on the subject for some years; see *Proceedings* of the Association, 1920–1926.

[11] See articles cited, note 2.

of governmental activities and of federal-state relations.[12] The implications of this changing pattern raise certain questions which will be discussed below; here it is enough to note their impact on constitutional doctrine.

But there are other political aspects of the question which it is not unimportant to note. Behind the law are the ballots. As Madison pointed out in No. X of *The Federalist*, there are many "interests" in the body politic—"a landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, (and) many lesser interests." At least two "interests" will be against any change in the tax-immunity rule: the holders of tax-exempt securities—a small but powerful interest; and the great body of public employees—over three million, who, with their families, constitute a not inconsiderable segment of the electorate. It is not necessary to impugn the patriotism of these groups to point out their stake in the ultimate decision on tax immunity. Is it not, indeed, the conflict of interest among various groups of taxpayers that in the last analysis determines the tax policy of government? Many such conflicts exist today which provoke widespread controversy and incite powerful pressure groups—witness current agitations over real estate taxes in the states, and the rapid organization during the last few years of state and local taxpayers' associations. If the rule is changed, the two groups especially affected are not likely to be entirely neutral during the debates upon it.[13]

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[12] On the growth of cooperation between the federal and state governments, amounting in some areas almost to a practical integration of policy and organization, see Clark, J. P., *The Rise of the New Federalism*.

[13] It is interesting to note that Madison pointed out in No. XLV of *The Federalist*, the reasons against "the alleged danger from the powers of the Union to the state governments"—that the number of employees (and their families) of the states would be far greater than that of federal employees. The proportion of those employed in the public services has greatly increased since 1789; the potentiality of organized pressure groups among them certainly has not declined.

Neither of the groups is at present highly organized or politically vocal. That security-holders do, however, exert powerful influence on fiscal policy in Washington needs no elaboration. It is not unlikely that contemporary sentiment in Wall Street and elsewhere, that amendment rather than legislation is the proper procedure, may emanate from this group, uncoordinated as its organized expression may be. The process of amendment is comparatively dilatory, and the object of an amendment more easily frustrated in state legislatures than in Congress. It would only be an illustration of Madison's insight into the habits of pressure groups in a Great Society were this particular group to favor a procedure of delay in the abolition of a governmental favor.

The employees of government, national, state, and local, form a much larger but probably less well-organized and on the whole less alert and cohesive group. Although there are many organizations of public employees, some closely allied to wider groups of organized labor, it is unlikely that they will offer effective opposition to the abolition of tax immunity—although their interest is probably greater (in the personal sense) and the equities in their case stronger. Comments like Westbrook Pegler's touch a sensitive nerve when they are applied to individuals. Moreover, those civil servants who will be substantially affected are in the upper salary brackets in the public services. They are, therefore, on the one hand, exposed to whatever considerations of jealousy operate in such cases, and, on the other, rather remote from immediate contacts with the rank and file, themselves almost unaffected by the abolition of tax immunity.[14] Considerations of their practical effectiveness as well as of expediency (the motivations of "patriotism" and special privilege) suggest that the "interest" of the

[14] Brabson, *op. cit.*

career services will not form an important pressure group in opposition to the ending of tax immunity. What pressures there are on this side of the issue are more likely to come from the first group than the second; neither will in all probability offer open or very active opposition. Indeed, the legislation is likely to pass by default so far as debate in Congress is concerned. There is no active spokesman of the civil-servant group in either house; of the other group, there are, of course. numerous representatives, just as there have been from the days of the Constitutional Convention.[15] But no more now than then is the expression of this "interest" likely to be explicit or vocal. If the politics of delay wins, and amendment is preferred to "a short and simple statute," the sources of the arguments—and the votes—will make an interesting study in group pressures.

There is a third phase of the politics of tax immunity which deserves notice in a discussion of its future. The doctrine was elaborated as a part of Mr. Chief Justice Marshall's effort to enhance federal powers as against the states. It was deducible from the theory of the theory of coordinate spheres of government, each independent of the other, and each performing functions long recognized as the proper purposes of all government. One hundred and twenty years ago, a simpler economy and less complex social pattern made the question of what is an essential governmental function almost irrelevant. All governmental functions actually engaged in by the nation or the states fell well within the traditional boundaries of the legitimate province of the state.

The last 120 years have produced profound changes in the range and scope of governmental functions—and theories about them. The Supreme Court was not faced with a concrete issue in the field of state tax immunity until 1905

[15] Beard, C. A., *An Economic Interpretation of the Constitution.*

in *South Carolina* v. *U. S.*[16] It there attempted to draw a line between functions of "a strictly governmental character" and those of "an ordinary business." Since then the Court has been confronted by many, and more difficult, situations where the process of what Mr. Justice Holmes called "pricking out a line" in this field has become, if not illusory, certainly highly artificial and logically irreconcilable.

This leads at once to a reconsideration of the whole question in terms of the present—and future—activities and services in which the national and state governments will be likely, as a result of the changing concepts of the purposes of the state as reflected in public opinion, to engage. The distinction drawn in *South Carolina* v. *U. S.* has proved impracticable to apply with any logical precision to the many new functions which have emerged as normal governmental activities; *Helvering* v. *Gerhardt* indicates how confused the thinking on this question is, how great a "lag" there is between judicial and legislative opinion.[17] And there is a further point which may be mentioned. The distinction no doubt draws a good deal of sustenance in judicial opinion from the interpretation which has been given to the concept of private property under the Fourteenth Amendment, since Mr. Justice Field's dissent in the *Slaughter House Cases*.[18] So long as public opinion supports the contemporary institutional pattern of economic behavior and organization, it is unlikely that judicial opinion will pioneer in recognizing the "governmental character" of these newer activities and services.

This dichotomy between the felt needs of the people as reflected in legislative policy and the cultural concepts

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[16] 199 U. S. 437, 26 S. Ct. 110, 50 L. Ed. 261.

[17] Perhaps the most acute analysis of this very interesting question is by Dicey, A. V., *Lectures on the Relations Between Law and Opinion in England,* Chap. 11.

[18] 16 Wall. 36, 21 L. Ed. 394 (1873).

inherited from an earlier and simpler economic-social pattern in this country suggests that the distinction is one that will be increasingly difficult to apply—or to justify. The caution expressed in legal circles [19] about applying a non-discriminatory income tax to state officers as distinguished from state employees rests on grounds of precedent, not of logic. If tax immunity is to be removed from any categories of state (and federal) officials, there seems to be no inherent reason—except politics—to substantiate a distinction between different groups. Unless the functions of the state are conceived of in nineteenth century terms (for instance, as defined by J. S. Mill) then the governmental character of some of the more recently developed activities is not, in terms of the contemporary needs of the body politic, less central to the state's *raison d'etre* than the older and more orthodox. If precedent is to be abandoned in favor of the logic of a consistent tax policy, distinctions drawn in deference to precedent may well be eliminated from the legislation (or amendment) which defines it. Here, however, a new "interest" emerges as an important factor in forecasting action. Will legislators and judges be sufficiently detached in their consideration of the question of tax immunity to include within the categories of non-immunity the very groups who will enact and interpret the necessary legislation? Certainly the contemporary conceptions of the service state—as well as equity—impel but a single answer to that question; the answer clearly should be in the affirmative.

Some Equities in Tax Immunity

If political considerations seem to indicate that tax immunity will, at least in large part, be abandoned, it is perhaps useful to review some aspects of the equities in-

[19] U. S. Department of Justice, *op. cit.*, pp. 69–71.

volved.[20] Here a distinction may be drawn between holders of government securities and government officials.

As to holders of government securities, students are unanimous in believing that the loss of revenue from the exemption of these securities from normal income taxes is greater than the gains from lower interest rates accruing to the issuing governmental units. Interest differentials amount on the whole, apparently, to less than ½ per cent. In a period of falling interest rates like the present, the differential may well become less (although this is not by any means certain for the economically stronger units). Whatever the differential, however, tax-exempt securities for the most part come into the hands of tax-exempt institutions or individual holders in the higher income tax brackets. This situation creates a privileged group of taxpayers capable thereby of avoiding the payment of income tax on a considerable share of their holdings.

There seems to be no reason of economic expediency why the situation should continue. The abolition of tax immunity would not materially affect the marketability of governmental securities at any income level. They would still prove attractive to large purchasers by reason of their relative security—and, if not, would thereby release substantial amounts now diverted to government securities for investment in private undertakings. From the point of view of small investors, the tax-exempt feature of government securities plays little part in determining purchase, since it will affect them only incidentally. And it is likely that small investors will play a more important role in the future in the marketing of this type of security. For the relative security which "governments" offer is an increasingly significant factor in the investment judgment of

[20] On this question, see Chapter I by James W. Martin, and Chapter VI by Roy Blough.

this group. While the amounts involved, in terms of present-day budgets (at least from the point of view of the federal government) are not large, the sharing of tax burdens on the basis of ability to pay seems economically and logically sound. And many state governments would probably derive from the steadily mounting national debt not unimportant accretions to their income tax receipts from this source. Equity and economics, as among taxpayers and as between the national and the state governments, suggest that tax immunity be ended here at the earliest possible date.[21]

There remains the question of the tax immunity of government officials. Here the amounts involved are of no great consequence.[22] But the degree of popular feeling on the question is steadily mounting. "This little inequality which deprives the deadhead passengers on the ship of state of the privilege of paying taxes on equality with their fellow-citizens," as Westbrook Pegler puts it, is not pretty language to apply to over 3,000,000 public servants. But it is representative of widespread reaction to the present situation. While, of course, tax immunity under current exemptions affects only a fraction of the whole group, this fraction is the butt of charges of privileged protection against taxation which those performing comparable work in private employment must pay. It is caused, no doubt, by the increase in the relative proportion of people employed in the public services as compared with a century or so ago.

The answer given to the question is almost universally the same as for tax-exempt securities—abolish the exemp-

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[21] There is a large literature on this subject. Among other articles, see especially, Hinrichs, A. F., "Cost of Tax-Exempt Securities," *Political Science Quarterly* (1926), 271; Beman, L. T., *Tax-Exempt Securities;* Rowe, W. H., "Burden of Tax-Exemption of Government Bonds," 16 *American Economic Review* (1926), 653; Brabson, *op. cit.*

[22] Magill, and Brabson, *op. cit.*

tion. But are the equities involved the same? Is the public servant escaping a fair share of the tax burden by reason of the exemption? If the ability to pay is used as the criterion of taxability, is the civil servant actually on a par with those performing similar functions in private employment?[23]

As has been pointed out, the amounts involved are, from the point of view of government revenues, unimportant. This derives in part from the relatively large proportion of civil servants in the low-salary classes. Probably more than four-fifths would be entirely unaffected by the abolition of immunity. Of the remaining fifth, most would not have to pay a substantial tax on their salaries; the proportion having earned incomes over, say, $5,000, is for both federal and state-local governments small.[24]

It would be useful to apply existing rates of tax to different categories of taxpayers—single, married, with dependents, etc.—at the different salary levels paid in public employment, to discover the actual incidence of such taxes on these groups. The data for such a study are probably not available at present. It is not unlikely, however, that the tax would affect more groups (for instance, among unmarried teachers of long service) than is commonly supposed.

But it is as to this small group of higher-paid officials, and, *pari passu,* of other groups at lower salaries, that the question of equity is most pertinent. It is generally true that throughout public employment, except perhaps in the labor and clerical grades, salary scales are lower than for comparable private employment. The differential probably

[23] See especially Chapter I of this volume.

[24] In the Hearings of the House Committee on Ways and Means (cited in NOTE at end of chapter), pp. 89-90, there are data that only 1.61 per cent of the state and local employees, and 4.01 per cent of federal employees have salaries of $4,000 and over. This does not include the small group of "officers" most of whose salaries would be above this limit.

increases as the salary levels advance; higher administrative functions are almost universally—and notoriously—paid below the levels in industry, commerce and finance. The question arises, therefore, whether taxability is actually the same for those public officials most likely to be affected by the abolition of immunity. While it is probably true, as Mr. Justice Stone pointed out in *Helvering* v. *Gerhardt,* that "a non-discriminatory tax laid on their net income . . . could by no reasonable probability be considered to preclude the performance of [their] function[s]" by civil servants, the Justice admitted in the same opinion that "to some unascertainable extent, a tax [would] deprive the states of paying less than the standard rates for the services which they engage." This is the very nub of the problem. No doubt, it is difficult to ascertain exactly the differential in the various types of public service. But few would argue that school teachers, the principal officers (and the rank and file) of the technical services, and other similar civil servants are today at salary levels commensurate with their responsibilities or with an extravagant standard of living. No doubt the government services offer relatively greater security (although only a few of the services provide adequate pension allowances). This is a factor in favor of government service, which partly—but only partly—offsets the salary differentials. Tax immunity is another factor, somewhat intangible, but none the less real, in the nexus of considerations which underlies and supports the morale of public officials.

No forecast can, of course, chart the effects of the abolition of immunity on the character, ability, and training of future candidates for the public services. But whatever militates against a broad base for selection into these services—and the intangibles are important in this respect—needs careful weighing before being enacted into public

policy. Are the equities all on one side of the question, when such considerations as these are balanced in the scales?

Here, too, the question of what are essential government functions is pertinent. If distinctions are drawn between different categories of officials (e.g., elective vs. appointive) or between different governmental activities (e.g., governmental vs. proprietary) in the actual redefinition of immunity, it is difficult to envisage an equitable basis for distinction. Are school teaching, fire and police protection, social work, labor regulation—and many other functions—of "a strictly governmental character?" Are park administration, communications, the services of supply, and the like, purely proprietary? Unless the unity of governmental function and activity in the modern state is recognized, equity will hardly be achieved—and perhaps not then—in the abolition of the tax immunity of public officials.

NOTE: The bill (Public Salary Tax Act of 1939, 76:1 H.R. 3790), referred to in footnote 1, applies only to income taxes on governmental salaries. It covers "an officer or employee of a state, or any political subdivision of, or any agency or instrumentality of any one or more of the foregoing." The bill, therefore, avoids one aspect of equity discussed above, viz. a classification of officials which would exempt some and include others.

Title I, Section One, of the bill includes in "gross income" liable to income tax salaries received by all persons in the categories noted above. Section Two removes the exemption of teachers in Alaska and Hawaii after December 31, 1938. Section Three provides that "the United States hereby consents to the taxation of compensation, received after December 31, 1938, for personal service as an officer or employee of the United States, any territory or possession or political subdivision thereof, the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, by any duly constituted taxing authority having jurisdiction to tax compensation, if such taxation does not discriminate against such officer or employee because of the source of compensation."

Title II of the bill seeks to prevent retroactive application of federal income taxes to any of the categories included in the bill, and provides for credit or refund under specific conditions, of any such taxes collected for compensation received prior to December 31, 1937, and for those employed since that date, or with a right to credit or refund, prior to December 31, 1938. It does not apply to compensation received directly or indirectly from the United States (section 205).

The House of Representatives has before it a *Report of the Joint Committee on Internal Revenue Taxation* (1939) on this aspect of the

revenue laws. This is in effect a brief justifying the application of income taxes to both income from state and local securities and salaries. The *Report of the Committee on Ways and Means* (76:1, House Report 26) is in the same vein. Hearings had been held by the Committee on January 26, 1939, on the general subject in view of the President's Message on January 19. Representatives of the Treasury, the Bureau of Internal Revenue, and the Department of Justice testified in favor of the proposal. Legislative agents of the National Association of Fire Fighters, the National Education Association, and the American Municipal Association (by letter) urged that protection against the retroactive application of taxation be inserted in the bill. A delegate of the Conference on State Defense, representing the Attorneys-General of 42 states, protested all legislation on securities taxation and retroactive taxation of salaries.

In the debates in the House, the Republicans led in the attack on the bill, urging the necessity—or at least the greater propriety—of constitutional amendment rather than mere legislation. It was pointed out that "considerable objection" might be evoked "from many fronts" to the subjection of income from securities, while there was general agreement on and much popular support for taxation of salaries, and that the Committee on Ways and Means had, therefore, separated the two proposals in order to allow more detailed study of the former. This procedure may well delay action on that issue indefinitely. In point of fact it is a much more significant one as to both the amount of revenue accruing to the federal government and the equities (and practical application) of the tax laws to various income groups. This bill in effect seems to be a concession to political pressures both positive and negative. Popular demand for taxation of salaries, whatever its true extent, can be met by the enactment of such legislation—with a show of heeding *vox populi*. The real resistance from the groups now benefiting from it to the more important abolition of tax immunity for income from government securities may well succeed in postponing legislation altogether, or diverting Congressional action to the cumbersome, and perhaps finally ineffective, procedure of amendment.

PART FOUR

SUBSISTENCE AND OTHER EXEMPTIONS

CHAPTER VIII

THE LEVEL OF PERSONAL INCOME TAX EXEMPTIONS

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The exemption of a minimum amount of net income is a widely accepted principle of personal income taxation. The fact that the amount of this exemption usually varies with the size of family implies that the amount has been determined by some measure of a minimum of subsistence or standard of living; but the ever growing pressure for revenue, and, in opposition, the administrative difficulty of taxing very small incomes, have doubtless played their part in determining the amount of these exemptions.

History

The history of personal income tax exemptions in the United States throws light on the current problem. The development of such exemptions cannot be traced in detail, within the limits of this paper, but some of the more important trends should be noted.

The federal tax of 1913 introduced exemptions of $3,000 for single persons, and $4,000 for heads of families. These exemptions were reduced to $1,000 and $2,000, respectively, in 1917; and, while they were raised again in the nineteen-twenties, they have never been restored to their original level.

The year to year variations of the federal tax have obviously been dictated by governmental need for revenues, rather than by changes in subsistence minima or standards of living, since the decreases for single and married persons coincide with the increased need for revenue in the war and depression periods, and the increases coincide with the relative plenty of the nineteen-twenties. The exemption for dependents, on the contrary, has risen steadily. None was given in the original law. In 1916 a \$200 exemption was introduced, and this was increased to \$400 in 1921, where it has remained.

Under the original law the single person was favored, as compared with the head of a family, the exemption for the latter being only one-third greater than that for the former. Today, the exemption of \$2,500 for the head of a family, as compared with \$1,000 for the single person, favors the head of a family.

State provisions for personal income tax exemptions show trends similar to those found in federal legislation. In 1913 only Wisconsin, of those states with personal income taxes, gave the head of a family a greater exemption than a single person, and made additional allowance for dependents. And even in Wisconsin the advantage was given to the single person,—the exemption for a married man without children being less than double that allowed for the single person. In all other states with income taxes at that time, the exemption for a married man was the same as that for a single person.

Today, all states have differential exemptions for married and single persons, and additional exemptions for dependents; and only five states out of thirty-one with personal income taxes (excluding those states taxing only income from intangibles) grant married persons an exemption less than double that granted to single persons. In contrast,

twelve states grant married persons exemptions that are more than double those of single persons, and fourteen states grant married persons exemptions just double those allowed single persons.

State personal income tax exemptions have tended to follow federal income tax exemptions, having been influenced both by the federal precedent and by the same fluctuations in revenue needs. The general trend of exemptions has been downward, except for exemptions for dependents. Where exemptions differ from those of the federal law, they tend to be lower. Only four states have higher exemptions for single persons than those granted by the federal government, and only two states have higher exemptions for married persons and dependents; whereas eight states have lower exemptions than those of the federal tax, for single persons, and eighteen states have lower exemptions for married persons and for dependents. The lowest exemptions found in any state are $500 for single persons, $1,200 for married persons, and $200 for dependents.

One important innovation in state legislation, for which there has been no federal precedent, is the deduction of personal exemptions from the lowest bracket instead of the highest, through the deduction of a flat amount from the tax, computed without exemption, in place of the deduction of a fixed sum from income before computing the tax. This was introduced in Wisconsin in 1927. In 1938 five states were using this form of exemption.

The exemption of a certain amount of earned income, which has been permitted under the federal law since 1924, except for a brief period during the depression, is not found in any state income tax law today. It is commonly found in European income taxes, although it often takes the form of a lower rate of tax rather than a specific exemption.

Comparison with Foreign Income Tax Exemptions

Comparison of personal income tax exemptions in the United States with those in foreign countries have limited value, owing both to differences in the costs of living and differences in the standards of living.

All the usual comparisons, however, indicate that exemptions are substantially higher in the United States than in European countries. In Great Britain, for example, a married man with no dependents, and an earned income of $2,750 (converting at $5 to £1) pays a tax of $228. A man in similar circumstances in the United States pays no federal tax at all. Other comparisons, which do not depend on an arbitrary ratio between the two currencies, can be made. Great Britain, with a population that is scarcely more than one-third that of the United States, had 60 per cent more taxable returns than the United States in 1935. Moreover, the income on which taxes were actually levied amounted to 32 per cent of the national income in Great Britain in 1935, and only 7 per cent of the national income in the United States in the same year.

In Germany exemptions are even lower than in Great Britain, reaching earned incomes of $224 for single persons and $330 for married persons without dependents (converting at 40 cents to 1 mark). The corresponding British exemptions are $500 and $900, with additional allowances for earned income. Our federal exemptions are nearly three times as high for single persons, and more than four times as high for married persons.

State income tax exemptions in this country tend to be lower than the federal, as noted above; but the lowest of these is probably higher than the British level, whatever the measure used, and is certainly higher than the German level.

Factors Determining Reasonable Exemption Levels

The argument for reducing personal income tax exemptions is twofold: first, that the personal income tax represents the best single measure of taxpaying ability, and as long as government need for revenues outruns income tax yields there is a case for lower exemptions; and second, that it is increasingly important to develop tax consciousness, in view of the increasing stake of the poorer half of the population in government spending.

If it is desirable that the tax system as a whole should be progressive in its incidence, then there is ample room for the substitution of personal income taxes on the lower income groups for sales taxes and other regressive taxes. A recent study of tax burdens [1] shows that the total tax burden—federal, state, and local combined—is progressive for the higher income groups, subject to personal income and estate taxes; but markedly regressive for families below the personal income tax level. And the great majority of the people, unfortunately, are in the group subject to regressive taxation.

State retail sales taxes and federal excises and customs duties are probably the most regressive of our important taxes. Retail sales taxes are now providing our states with more income than personal income and death taxes combined. And federal excise taxes yielded more than federal personal income, estate, and gift taxes combined in 1937–38.

Regressive taxes have grown more rapidly than progressive taxes in the past decade. A reduction in personal exemptions for the income tax would help to restore the balance. Estimates in the Twentieth Century Fund study, cited above, indicate that a reduction of personal exemptions to $500 for single persons, $1,000 for married persons,

[1] Twentieth Century Fund, Inc., *Facing the Tax Problem*, Chap. 16.

and $200 for dependents, would (applying 1936 tax rates to 1928 incomes) increase the revenue from the federal tax about $500,000,000 above the yield with the present level of exemptions. This would only be sufficient to replace between one-fourth and one-third of the revenues from federal excises last year (1937–38), or all but those on liquor and tobacco.

Turning to the question of tax consciousness, the federal taxable returns of 1934 represented about 2.5 millions (counting both husband and wife for joint returns) of the 75 million adults in the United States, or between 3 and 4 per cent.[2] The Twentieth Century Fund study estimates that if exemptions had been at the $500, $1,000 and $200 level noted above, the taxable returns of this year would have represented more than one-fifth of the adult population (16.5 millions, or 22 per cent). The recent estimates of the National Resources Committee,[3] of the number of incomes in the various income classes in 1935–36, indicate that a tax with these low exemptions in the latter year would have reached an even larger proportion of the adult population.

Even if the desirability of reducing exemptions below the present federal levels is accepted, there is still the question of how great a reduction should be made. The Twentieth Century Fund Committee on Taxation recommended the reduction of personal exemptions to the level given above. The Committee of the Tax Policy League on the Place of State Income Taxation in the Revenue Systems of the States recommended a similar level of exemptions in 1935. The Committee of the National Tax Association on Model Plan of State and Local Taxation, in its 1933 report,[4] sug-

[2] *Ibid.*, p. 355.
[3] *Consumer Incomes in the United States.*
[4] National Tax Association, *Proceedings,* 1933, p. 373.

gested exemptions of $600 for single persons, $1,200 for married persons, and $200 for dependents. This recommendation was for state taxes. All these recommendations are materially below present exemptions.

The choice of these or other levels must depend on many things. It depends partly on government need for revenues, partly on what constitutes a minimum of subsistence or reasonable standard of living, partly on the importance of extending tax consciousness, and partly on administrative feasibility.

Today, government need for revenues favors the lowest possible exemption. It can be ruled out as a factor in determining the exact level of exemptions, however, since it is apparent, from the figures given above, that the maximum possible reduction that can be contemplated in this country today will not result in an increase in revenues sufficient to replace the regressive taxes in our system.

The question as to what constitutes a minimum of subsistence, or decent standard of living, can be approached from the standpoint of the cost of a reasonable, healthful standard, or from the standpoint of actual expenditure. Cost of living studies for the purpose of ascertaining the cost of a "reasonable, healthful standard," vary greatly with time, place, and occupation, and with the ideas of the investigator. The writer has not made an extensive study of this problem, but of seventeen studies of the cost of living cited in a recent book on consumption,[5] none sets the cost of a reasonable standard at anything approaching the $4,100 exemption now available under the provisions of the federal law, to a family of five with earned income. Only five of the seventeen standards exceed the $1,600 that would be available to such a family under the lower of the two suggested exemption levels given above. The wide variation

[5] Charles Samuel Wyand, *The Economics of Consumption.*

in these standards, however, demonstrates their limitations as a guide to reasonable exemption levels. Even if agreement could be reached as to the elements of a reasonable standard, the cost of this standard would vary widely with time and place.

Actual budget studies show that families on very small incomes spend, on the average, more than their incomes. This, in itself, indicates lack of taxpaying ability. Families with higher incomes, on the contrary, show increasing savings. The dividing line between deficits and savings varies in different studies, depending on time, location, and occupation of the group in question; but in general savings begin on incomes of around $1,000. Most budget studies, also, place the cost of living for a single person at approximately two-thirds the cost for a married couple. It is apparent that budget studies, too, have limitations, but it seems probable that a thorough study of budgets and costs of living would be extremely valuable in determining a reasonable level of personal exemptions.

The importance of tax consciousness increases as the vested interest of the small income classes in government spending grows. In the interest of achieving a responsible electorate, it may seem desirable to extend the income tax below the margin of a reasonable standard of living, and below the point where the returns seem to justify the cost of administration. In fact, this points to the desirability of reaching more than half of the voters—perhaps all—through direct taxation. It seems probable, however, that if this is to be achieved, the income tax is too elaborate a tool. A simple poll tax is more probably the proper agent.

Under present conditions, the lower limit of exemptions is probably set by administrative feasibility, rather than by government need, taxpaying ability, or the need of developing tax consciousness. Any reduction in personal exemp-

tions will increase the administrative problem out of proportion to the added revenue, both because the tax yield per return is necessarily small for the lower incomes, and because the people with smaller incomes are less apt to keep systematic accounts, and many are incapable of making out even a simple return.

A filing fee is sometimes suggested as an aid in administration. The fact that all recipients of income must make returns under this system tends to prevent evasion. Such a fee was in operation in Delaware for a few years, and administrative officials reported that it was of material assistance in collecting the tax. Utah, also, imposed such a fee for a short time. The filing fee was favored by the National Tax Association Committee on Model Plan of State and Local Taxation, not merely to aid in administration, but also to extend tax consciousness. The objections to a filing fee are its regressive nature and inevitably small yield.

Collection at the source is another possible aid to administration when exemptions are small. It is widely used in those countries with low income tax exemptions, and has apparently been satisfactory. Collection at the source has long been established as an essential feature of the British tax on many types of income. In Germany, where exemptions are even smaller than in England, workers deposit tax cards with their employers when they accept employment. These cards are issued by the government and give the essential information concerning dependents (and consequent tax exemptions). Employers then deduct the appropriate tax, determined by monthly, weekly, or even daily and hourly rates of pay, from the workers' wages. This system adds to the work of the employer, but this can be minimized, as it is in Germany, by using the same return for income tax and social insurance. In fact, it seems quite

possible that the burden on the employer might be no greater than that imposed by some substitute tax.

It has the disadvantage, from the taxpayer's point of view, that the amount of the tax varies with his rate of pay rather than with his annual earnings. A tax designed to exempt a man whose rate of pay was such that his annual earnings would be $1,000 in a year of full employment, would take a substantial sum from the man with a rate of pay such that his annual earnings would be $2,000 in a year of full employment, but who earned only $1,000, in fact, because of half-time employment. The difference is only one of degree, however. No attempt is made, under our federal law, to reimburse the man who earns a taxable income one year and is unemployed the next.

Exemptions as low as $500 for single persons, $1,200 for married persons, and $200 for dependents, are now in effect in some of our states. No attempt has been made, however, to collect at the source, and it is quite possible that substantial reductions could be made in present federal exemptions without resorting to collection at the source. An official administering the South Dakota tax reports no unusual difficulty in administering a tax with $600 and $1,200 exemptions.

In the opinion of many tax economists, the difficulties of administering income taxes with small exemptions are not as great as the difficulties of administering sales taxes successfully.

The Relation of the Level of Personal Income Tax Exemptions to the Tax System as a Whole

Turning from the problem of the determination of the exact level of personal income tax exemptions to the relation of the level of exemptions to the tax system as a whole, it is apparent that this level should bear some relation to

the level of estate and inheritance tax exemptions, since these taxes, too, are progressive taxes with exemptions that assume some minimum provision for the heirs. This implies that the exemption for the estate or inheritance tax should be approximately equal to the capitalized value of the income exempted from the income tax. No exact solution can be offered, in view of the wide variations resulting from the varying rates of interest that may be selected for calculating the capital value. Moreover, especially in the case of an estate tax, it is necessary to make some more or less arbitrary assumption as to the incidence of the tax, since either the exemption for the single person or that for the head of a family might be used.

The relation of the level of exemptions to the regressive taxes of our tax systems has already been considered. It is sufficient to repeat here that substantial reductions in the levels of both federal and state income taxes will have to be made if our federal and state tax systems are to be progressive in their incidence for even a substantial minority of our taxpayers.

No consideration of the level of personal income taxes can ignore the fact that we have, in most of our states today, a dual system of income taxes; and, if exemptions are to be reduced, the question arises whether the reductions should be for the federal tax, the state tax, or both. This problem would be most easily solved by a uniform federal tax shared with the states. But such a solution is highly improbable in the immediate future—and perhaps it is not even desirable.

If the choice must be made between state and federal governments, the first consideration is as to the relative need of these competing jurisdictions for revenue. On the one hand, federal expenditures, as a whole, greatly exceed state expenditures as a whole; and the federal government

can probably administer an income tax more effectively than state governments. Moreover, the federal government does not have access, as do the states, to the property tax, which has been the largest single source of revenue in the past. On the other hand, the state must share the property tax with local governments, if not turn it over to them completely; and state and local needs combined easily rival federal needs. And, while the federal government is better able to administer a tax on large incomes (and perhaps has a peculiar claim to these) the state can deal effectively with the small income taxpayer, who usually lacks both the freedom of movement and the incentive that his wealthy neighbor has.

In practice, there has been a tendency for state governments to tax smaller incomes than the federal government, and to levy a smaller rate on large incomes than the federal rate. In view of the less urgent need of a uniform tax on small incomes, and the fact that these incomes are apt to be more local in origin, it has often been suggested that federal exemptions should be generous, and that the taxation of small incomes should be left to the states. In view of the tendency for states to accept the lead of the federal government in incomes taxes, however, it may be necessary for the federal government to establish the precedent of taxing smaller incomes if these are to be taxed. If the initial federal rates are moderate, two taxes on these small incomes are still possible.

Conclusions

It is apparent from the foregoing that no specific level of exemptions can be defended. It is believed, however, that certain changes in present personal income tax exemptions can be made with profit.

First, the deduction of exemptions from the lowest

bracket, instead of the highest, through the deduction of a fixed sum from the tax computed without exemption, should not only produce substantial additional revenues, with no change in the total-exemption level, but would bring the effective rate of the tax nearer to the nominal rate, and hence nearer, in all probability, to the rate of tax intended.

Second, the exemption for a head of a family should probably be so adjusted to the exemption for a single person, that the one is just double the other—unless a tax on bachelors is intended. Certainly none of the cost of living studies justifies the relatively more favorable exemption now granted to heads of families.

Third, a substantial reduction in the level of personal exemptions, for both the federal tax and those state taxes with the larger exemptions, would, in the writer's opinion, be a desirable substitute for excises and sales taxes. Both fall, in part, on the lower income groups, but the income tax with low exemptions is progressive in its incidence, whereas the sales tax is regressive. Moreover, the reduction of exemptions does not result, as does the sales tax, in the taxation of those on relief.

The administration of a tax with substantially lower exemptions is believed to be feasible. It is not at all certain that it would require collection at the source. And collection at the source is, perhaps, not out of the question. If collections can be co-ordinated with social security payments, the burden on the employer is not materially increased. And if the amount of the tax is determined by weekly or monthly wages, rather than annual wages, there is no problem of refunds. It can even be argued that the tax payment at the time income is received works less hardship than the tax falling due a year after the income has been received.

Finally, there seems to be no compelling reason why the

federal government should leave this source of revenue entirely to the states. If, however, the federal government should reduce the level of its personal income tax exemptions materially, it is important that the levies on small incomes should be so low that there is room for a state tax on the same incomes without overtaxing the small income group.

CHAPTER IX

DEATH TAX EXEMPTIONS

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Death taxes are an important source of revenue only in England, where they produce nearly ten per cent of the tax receipts. In this country they yield less than five per cent of the total federal, state, and local tax revenue; they rank behind property taxes, corporation and personal income taxes, gasoline taxes, liquor taxes, and tobacco taxes. Elsewhere, too, inheritance or estate tax receipts are of trifling importance.

It might seem unreasonable to devote an extended discussion to a minor phase—exemption—of a minor tax. And so it would be if death exemptions raised only the same or similar issues as those raised by the other taxes already discussed or to be discussed in subsequent papers. But the exemption problem in death taxation is *sui generis*. The death tax is an exception to the constitutional principle, discussed earlier by Commissioner Martin, that the federal and state governments can not tax each other's instrumentalities. The "ability" and "sacrifice" principles usually set forth as distributive justifications for tax exemption are, in the case of death taxation, blurred by the indefiniteness of the relationship between inheritance and these distributive principles, and are further tangled by the presence of relationship discrimination in inheritance taxation.

Furthermore, the ordinary principles of administrative exemption—to save costs of assessment and collection where the tax return will be trifling—do not apply in all strictness to the death tax. Most of such costs are taken over by the probate function, which must be exercised whether or not any tax is assessed and collected. And finally, the attempt to make the federal estate tax and the various state death taxes complementary levies has given the minimum exemption of the federal estate tax a peculiar character not found in any other American tax exemption. Inheritance and estate tax exemptions may not be of great revenue importance, but they are a happy hunting ground for fiscal theorists.

Present Status of Death Tax Exemptions

Before analyzing the theory of death tax exemptions, it will be wise to summarize current provisions for such exemption, at least those found in American taxes.[1] We shall have frequent occasion subsequently to assume a general knowledge of these American death tax exemptions.

The present federal estate tax is really two taxes having different minimum exemptions and rate schedules imposed on the same base. The "normal" tax, on which the eighty per cent state death tax credit is based, has a $100,000 exemption. The supplementary tax, allowing of no state tax credit, has a $40,000 exemption.

State estate taxes, as an exclusive method of death taxation, are found in nine states. The minimum exemptions of these state estate taxes vary from $10,000 in Utah, to $100,000 in Alabama, Florida, and Georgia, whose estate taxes are merely parasitic enactments of the federal tax

[1] For a full tabulation of death tax exemptions, interested readers are referred to Tax Research Foundation, *Tax Systems of the World* (1938 ed.), pp. 150 and 365.

credit; in Florida and Georgia, incidentally, the tax applies only if the estate exceeds $250,000. In addition to these nine exclusive estate taxes, supplementary estate taxes, imposed to take advantage of the federal credit, are found in most of the other states which levy inheritance taxes. Because of the relation of these supplementary estate taxes to the federal estate tax, they all have the same minimum exemption—$100,000.

Exemptions under the thirty-eight state inheritance taxes vary so widely as to amounts and as to graduation in amount according to the relationship of the beneficiaries to the deceased, that no generalization can be made. New Hampshire's inheritance tax is limited to collateral heirs and beneficiaries—such part of an estate as passes to direct heirs of the deceased is completely exempt. The Kansas tax allows the most generous minimum exemption—$75,000 on property passing to a widow. From this maximum, exemptions grade down to $100 or none at all on bequests to distantly related or unrelated beneficiaries.

Constitutional Considerations

As all students of American taxation are aware, a property tax cannot extend to federal securities. State personal income taxes must either exempt interest on federal debt issues or otherwise exclude it from the taxable base; a corresponding cross-exemption or exclusion must appear in the federal personal income tax. Until the recent revival of the subject-measure rule by the Supreme Court, corporation income taxes suffered from the same limitation. State gasoline and sales taxes cannot apply to sales to federal agencies. This "governmental instrumentalities" limitation applies to the entire list of federal and state taxes—except to death taxes.

A quirk of reasoning by the Supreme Court in *Plummer*

v. Coler[2] saved inheritance and estate taxes from this constitutional limitation. The argument in this decision is utterly out of line with subsequent basic trends of judicial reasoning, but it has stood over nearly half a century, and has every appearance of continuing as a fixed element of our judicial tax law.

Fortunate indeed it is for death taxation in this country that the Supreme Court has never sought to undo the happy paradox of *Plummer v. Coler*. Sales to government agencies cannot be expanded arbitrarily in order to avoid sales taxes. Wealthy individuals cannot shift all their wealth into tax-exempt securities to avoid income taxation and still maintain control of the enterprises to which they are devoted. But were governmental securities also exempt from estate and inheritance taxes, such transformations of estates in anticipation of death would be a possible method of avoiding death taxes. With compulsory exemption of governmental debt issues from death taxes, or in other words without the paradoxical rule of *Plummer v. Coler*, we could not have the progressive estate and inheritance taxes now in effect in the United States.

Distributive Considerations

Minimum exemptions in death taxes are generally justified on distributive and sentimental considerations. Shall a heartless government, the argument runs, take food out of the mouths of the helpless widows and orphans, already deprived of their provider, by taxing the little inheritance that must be their sole support for years to come? Shall the small bequest to a needy brother or sister, or uncle or aunt, or other relative, be reduced to benefit a government which can obtain its millions of revenue from other sources?

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[2] 178 U. S. (1900) 115.

Shall testamentary generosity to an old faithful servant be defeated for the sake of a few dollars of revenue?

We should recognize at the outset that the ordinary "benefit," "ability," and "sacrifice" doctrines of tax justice commonly adduced in support of tax exemptions, run up against unusual obstacles when applied to death taxation. If an estate tax is in question, the "benefit," "ability," or "sacrifice" standards must be related to the deceased owner of the estate, since estate exemptions and rate provisions cannot be associated in any direct or indirect manner with the varying fractional shares of the estate transferred to the heirs and beneficiaries. To speak of "benefit," "ability," or "sacrifice" in connection with the dead is ridiculous, unless the estate tax is viewed as a "back tax"—a sort of cumulated property tax for which liability accrued during the lifetime of the deceased, but on which payment did not fall due until his death. And as a "back tax," an estate tax fails to conform to any standard of "tax justice," because of the varying terms of life of estate owners. What is true of the whole applies also to the part. No twist of "benefit," "ability," or "sacrifice" arguments can marshal any of these principles to the support of estate tax exemptions.

For an inheritance tax, the "benefit," "ability," and "sacrifice" doctrines must necessarily be related to the circumstances of the beneficiaries and heirs. "Benefit" arguments cannot be squeezed into the picture at all. And since any elements of "ability" or "sacrifice" on the part of the heirs and beneficiaries must be measured, not alone against their inheritances, but against their inheritances plus their other wealth, "ability" and "sacrifice" theories are also at a serious disadvantage. A Norwegian death tax of 1895 and a German inheritance tax of 1919 took "other wealth" of the heirs and beneficiaries into account in determining rates and exemptions. These provisions were soon dropped for adminis-

trative reasons in Germany, and no other inheritance tax laws have embodied this consideration. In the absence of this "other wealth" factor, minimum exemptions in an inheritance tax are as much a mockery of "tax justice" as minimum estate tax exemptions.

The general idea of minimum inheritance and estate tax exemptions may find no support in strict distributive reasoning, but one class of minimum exemption—that accorded to the surviving widow and minor children of the deceased—unquestionably makes a sympathetic appeal to popular ideas of "tax justice." It may well be that many widows and orphans are wealthy in their own right, and hence not dependent upon their inheritances for their future support. But legislators and the popular mind will insist that a majority of widows and orphans probably *are* dependent upon what a husband or father leaves to them. And the idea of intruding upon the sorrow of widows and orphans to inquire if they have resources other than their inheritance would shock American sensibilities. Every state that imposes an inheritance tax allows the surviving widow an exemption of at least $5,000; Kansas, with a $75,000 exemption to widows, marks the extreme of generosity along this line. The New York and North Dakota estate taxes provide that the first $20,000 of such part of the estate as passes to a surviving spouse is tax-free, and the generous general minimum exemptions in most of the other states are undoubtedly intended to relieve the tax burden on the deceased's immediate family.[3]

[3] Estate tax laws and wills are usually so drafted that the entire tax is paid out of the residuary estate. Many testators, unaware of the consequences of their action, so frame their wills that the widow and children are the residuary legatees, and thus bear the burden of the tax on the entire estate. Any general minimum exemption in an estate tax will obviously benefit such legatees.

Relationship Considerations

An interesting independent line of argument was used to justify the complete exemption of all property passing to direct heirs—the surviving spouse, parents and grandparents, children and grandchildren—found in most of the nineteenth century inheritance taxes. French scholars condemned taxation of inheritance by direct heirs both as destroying the family, the backbone of the nation, and because children should be considered coproprietors with their parents. Spanish writers insisted that direct inheritance taxes destroyed the persistence of family properties, essential to the preservation of the social order. Italian writers, most ingenious of all, protested that direct inheritance taxes caused children to be disrespectful to their parents since the tax reduced their expectations of inheritance, and that such taxes discriminated against rural regions since more rural property passes in the direct line than does urban property.[4] A number of English and American writers also drew upon one or another of these arguments to condemn inheritance taxes affecting direct heirs.

Except for the New Hampshire inheritance tax, complete exemption of direct heirs has disappeared in this country, but legislative inertia, or perhaps a lingering sympathy with relationship discrimination in the field of inheritance taxation, has maintained in many of our state inheritance taxes a graduation of exemptions according to the relationship of the beneficiary to the deceased. The Arizona inheritance tax law, for example, provides for six varying exemptions, ranging from \$10,000 to \$100, for different relationship classes of beneficiaries. Five-fold and four-fold exemption graduation is not uncommon in the state inheritance taxes.

[4] Citations of authors expressing these views are given in William J. Shultz, *The Taxation of Inheritance*, p. 266.

Note that these relationship discriminations in inheritance tax exemptions—except the allowance of an extra-large exemption to the widow and minor children of the deceased—can claim no support from general distributive justifications for tax exemption. As we have already seen, these justifications fail anyway when applied to death tax exemptions. And even if they had some validity, could it possibly be argued that a cousin has more taxpaying ability or sustains less of a sacrifice than a nephew similarly circumstanced and should, therefore, be allowed a lower exemption than the nephew, or that a brother has less ability or sustains more sacrifice than an uncle? Graduation of inheritance tax exemptions according to the relationship of the beneficiary to the deceased, like relationship graduation in inheritance tax rate schedules, rests flatly on the independent theory that a sanctity inherent in property transfers between immediate members of a family, is lacking in transfers between more distant relatives and between strangers, and that this distinction must be recognized by tax laws. It does not seem likely that this doctrine, stated baldly, would receive much support in the United States today. Hence we must judge the relationship graduation in inheritance tax exemptions still found in this country to be an archaic hangover which, together with the corresponding relationship discrimination in rate schedules, should be eliminated as soon as practicable.

Administrative Considerations

When the nature of a tax requires preparation of an involved return by the taxpayer, auditing of this return by a tax bureau, more or less of a follow-up to check evasion, and finally provision of space and facilities for filing the return and its attendant documents, the "overhead" administrative costs to be allocated to each return may well con-

stitute a substantial sum. Were no minimum exemption allowed, many tax payments would cost the collecting government more to administer than the amount of tax involved; for a still greater number, receipts and costs would just about balance, leaving no net revenue or else a net income so small that it would not justify the cost and the trouble to the "little" taxpayers. Hence, whether or not distributive considerations can be alleged in support of minimum income, business, sales, and other tax exemptions, the laws accord such exemptions as a matter of administrative expediency. As a general rule, the more readily a tax can be avoided or evaded, and thus the more extensive the administrative check required on the returns, the more generous must be the minimum exemption so that available administrative facilities can be concentrated on the larger, more productive returns.

Avoidance—legally dodging the tax by taking advantage of loopholes in the tax law as enacted or as construed by the courts—is the great problem in death tax administration. For years the statute draftsmen and the death tax dodgers have been running a neck and neck race. Nor has the size of the minimum exemption any influence on death tax avoidance—would-be avoiders possess large estates which would not be eliminated even under the most generous minimum exemptions. Abolition of minimum exemptions would add little or nothing to the work necessary to check death tax avoidance.

Death levies are peculiarly favored among taxes in that opportunity for their evasion, particularly in the case of large estates, is reduced to a minimum. Estate and inheritance tax returns are not prepared by the man who transmits an estate, or by the heirs and beneficiaries who would have strong incentives to evade the tax wherever practicable, but by executors and administrators who can have no

pecuniary interest in the reduction of the estate by taxation and who, moreover, are officers of a probate court and responsible to such court for their stewardship. In large estates, particularly, the conflicting interests of creditors and a multiplicity of heirs and claimants are likely to force a minute scrutiny of the executors' accounts. Connivance between executor or administrator and the heirs and beneficiaries to evade a death tax on a large estate is an extreme rarity. Such connivance occurs fairly often, however, in the case of small estates, where the administrator is likely to be the principal heir. Returns on small estates, therefore, must be examined thoroughly by the tax administration, and the sample check applied to these returns. By eliminating from administrative consideration the great mass of estates under $5,000 or $10,000, the exemption of these amounts removes a great element of unprofitable administrative expense.

There is no administrative justification for the exemption provision of the Florida and Georgia estate taxes—estates under $250,000 are not subject to tax, and all taxed estates are allowed a $100,000 exemption—or for the $100,000 exemption of the Alabama estate tax. As already pointed out, these taxes are merely parasitic levies based on the state tax credit of the federal estate tax. The states in question have abandoned all pretence of levying death taxes on their own account, and are, at no cost to themselves, taking the allowance under the credit clause.

The Federal Estate Tax Exemption

This criticism of large exemptions, however, does not apply to the $100,000 exemption in the basic federal estate tax or to the $40,000 exemption in its supplementary tax. The large exemption which has been a feature of the federal estate tax since it was first levied—$50,000 from

1916 to 1926, $100,000 on the basic tax since 1926, $50,000 on the supplementary tax from 1932 to 1936, and $40,000 since 1936—is an interesting attempt to effect partial separation of revenue sources as between the federal government and the states.

Competitive undercutting of inheritance tax rates was a peculiarity of state inheritance taxation until the federal estate tax credit was enacted in 1924. Such competitive rate cutting interfered seriously with the states' taxation of large estates, but had little if any effect upon their rates on small estates. A wealthy individual would find it both worthwhile, from a tax-saving point of view, and practicable to establish residence in one of the "tax haven" states. But the individual who would leave only a moderate estate, and whose retirement from his business was probably accomplished only by his death-bed illness, could not take advantage of these "havens." As a consequence, progression in state death tax rate schedules was not effective for estates larger than $50,000 to $100,000.

By allowing an estate tax exemption of $50,000, later $100,000, the federal government sought to impose a progressive tax on the large estates likely to escape state taxation. When the federal estate tax was first levied in 1916, it was expected that most states would subsequently level off their progressive death tax schedules at $50,000, thus killing the lure of the "tax haven" states. Had this occurred, the federal estate tax would have taken the form of a supplementary levy on larger estates. The result would have been a sensible type of tax separation—the states deriving their death tax revenue from small estates not susceptible to interstate tax competition, and the federal government, unaffected by such tax competition, drawing its tax from the larger estates.

This expectation was not realized. "Non-haven" states

continued their attempts to derive a substantial revenue from large estates, complaining bitterly the while of the hijacking activities of the "haven" states. In 1924 the federal government reversed its policy, and through the tax credit arrangement guaranteed a revenue from large estates to all states which taxed them within the scope allowed by the credit. With this change in policy, the federal government might well have extended its estate taxation to smaller estates. Since it did not need additional revenue at the time, and was instead reducing taxes, it chose in 1926 to increase the exemption of the federal estate duty from $50,000 to $100,000, thereby saving substantially in administration costs.

The present $40,000 exemption in the federal supplementary estate tax is determined solely by administrative considerations. With this exemption in effect, the Estate Tax Division of the Bureau of Internal Revenue need handle only 10,000 to 20,000 returns a year. A substantially lower exemption would multiply many times the number of returns to be examined.

Subsidy Exemptions

The so-called subsidy exemption—granted to encourage some extraneous action on the part of the taxpayer—has found two footholds in the field of death taxation. Testamentary bequests to religious, educational, and charitable institutions are exempt under the federal estate tax, and under most state death taxes, provided they are made to institutions within the taxing state. And in 1917, the federal government, Indiana, and Massachusetts granted death tax exemption to the estates of soldiers and sailors who died during the period of the war and for one year thereafter.

No serious criticism has ever been directed against the exemption of charitable bequests. Although the taxing

government loses an element of revenue, the institutions which benefit are generally considered to be using these funds as well as would the taxing government in serving the public interest. Moreover, to some extent the exemption may encourage wealthy individuals to make such bequests—though it is difficult to establish any cause-and-effect reasoning along these lines. If such bequests are thereby encouraged, and to the extent that they are so encouraged, the nation or state benefits.

Form of Death Tax Exemptions

American lawmakers know only one form of tax exemption—the continuing exemption. No matter how small or large an income, estate, or distributed share of an estate may be, the tax laws allow it the same exemption. Distributive and administration considerations posit only the *non-taxation of incomes, or estates, or distributed shares of estates under a certain size;* they do not require the allowance of this exemption to big incomes, or big estates, or big inheritances. No line of reasoning can make sense of a $2,500 exemption allowed against a $100,000 income, or a $40,000 exemption allowed against a $1,000,000 estate. Yet the tax laws persistently provide such continuing exemptions, with a consequent substantial loss of revenue to the taxing governments.

I am taking advantage of this occasion to continue my rather lonely campaign for the "vanishing" exemption.[5] As applied to the $40,000 allowance of the supplementary federal estate tax, the principle of the vanishing exemption would leave all estates under $40,000 free from tax liability just as does the present continuing exemption, but for each dollar that the estate exceeded $40,000 the exemption would

[5] See my *Taxation of Inheritance,* pp. 270–271; *The Fiscal Problem in New York State,* p. 186; *American Public Finance,* pp. 251–258; *Your Taxes,* pp. 153–154.

be reduced by one dollar—or perhaps, for administrative simplicity, the reduction of the exemption could be $1,000 for each $1,000 that the estate exceeded $40,000. An estate of $60,000 would thus be allowed a $20,000 exemption; one of $80,000 would be taxed on the full amount. The advantages of the "vanishing" exemption are that it neither continues into the higher brackets where it has no distributive or administrative justification, nor produces any inequitable abrupt jump in tax liability at any bracket. On a rough calculation, total annual tax liability under the present federal estate duty rates (not allowing for the state tax credit) is lower by $25,000,000 or more with the present continuing exemptions allowed under the basic tax and the supplementary tax, than if the exemptions were of the vanishing kind.

Summary of Conclusions

1. Distributive considerations afford no justification for inheritance and estate tax exemptions, except possibly to widows and minor children of the deceased.
2. Inheritance tax exemptions graduated according to the relationship of the beneficiary to the deceased have no current theoretical justification or popular approval.
3. Administrative considerations dictate that estates under $5,000 or $10,000 should, by exemption, be eliminated from state tax administration.
4. Death tax exemptions should be of the "vanishing" type.

CHAPTER X

SALES TAX EXEMPTIONS

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SALES taxes and sales tax exemptions are so diverse in character that the scope of this paper must be limited. First, the meaning of sales tax exemptions will be examined. This will be followed by discussion of a few broad general classes of exemptions. Finally, the reasons for the existence of some of these exemptions will be analyzed.

Before speaking of sales tax exemptions, there must be some agreement as to what is a sales tax. In a broad sense the taxes on the sale of gasoline, liquor, tobacco and other products are sales taxes, but these are commonly known as commodity taxes and will be excluded from consideration forthwith. The sales tax applies to the sale of commodities in general, although many classes of sales may be excluded from the tax base or may not be taxable because exempted. In 1938 there were 23 states that are ordinarily listed as sales tax states. Of these, 14 states also had a use tax to supplement the sales tax.[1] Since legally the use tax is not a sales tax but a tax upon the use, consumption, or storage of goods within the state that have been purchased outside the state, the exemptions from the use tax may be disre-

[1] States with both a sales tax and a use tax: Ala., Ark., Calif., Colo., Iowa, Kan., La., Mich., Miss., Ohio, Okla., Utah, Wash., Wyo. States with the sales tax only: Ariz., Ill., Ind., Mo., N. M., N. C., N. D., S. D., W. Va.

garded in a paper upon sales tax exemptions. It should be observed, however, that from the economic standpoint the exemptions from the use tax are much the same as those from the sales tax, except that sales which are taxed by one of these taxes are excluded from the other when a state has both a sales and a use tax.

In the 23 sales tax states the tax varies widely as to the scope of the taxable field, the list of exemptions, and the nature of the tax. The so-called sales tax may be designated in the law as a general consumers' sales tax, as in West Virginia; a general retail sales tax, as in Michigan; an excise tax upon the privilege of engaging in certain businesses and occupations, as in Arizona; a tax on the gross receipts from certain kinds of business, as in New Mexico; a retailers' occupation tax, as in Illinois; or a gross income tax, as in Indiana. In most of these sales tax states the tax is not limited to retail sales of tangible personal property. In some states, as in Arizona and Mississippi, the tax has more than one rate, with different rates applying to other classes of sales, such as wholesale sales. In addition to retail sales of tangible personal property, a majority of the sales taxes apply to one or more other classes of gross receipts, such as those from telephone service or admissions to commercial amusements. The Indiana gross income tax is levied not only on gross receipts from the sale of commodities, but upon those from the sale of certain capital assets such as land, and upon receipts of other kinds, such as wages, interest, dividends, and even alimony.

In view of the diversity in the scope of the tax base and in the nature of sales taxes, it would be inexpedient to attempt to discuss all of the exemptions now existing in each of the 23 states. Furthermore, a comparative study would be misleading, since often what is an exemption from the law of one state is not an exemption at all in an-

other if the sale is not within the tax base. This paper will be confined, therefore, to exemptions from the sales tax of certain classes of *retail* sales. As others have recently compiled tables listing the states having various exemptions, it would be needless repetition of a useful but tedious task to enumerate here the states having each kind of exemption.[2] When a particular exemption is mentioned as existing in a certain state, it will be for purposes of illustration only and does not imply that the same exemption is not found in other states.

Whether a sales tax *exemption* exists depends upon the nature of the tax base upon which the sales tax is imposed. If a particular type of transaction is taxed by the sales tax of one state but not of another, it is popularly assumed that the transaction is exempted by the sales tax law of the second state. Strictly speaking, however, there is no exemption unless the tax base is such that the transaction would be taxable if it were not definitely exempted. For instance, the Michigan sales tax is imposed upon the sale at retail of tangible personal property. Receipts from admissions, transportation, and telephone service, which are taxed under the retail sales taxes of some other states, are not taxable in Michigan. These are not sales tax exemptions in this state, however, because the receipts are not derived from the sale of *tangible personal property* and hence are excluded from the tax base. It would be as logical to say that wages and the sale of real estate are exemptions from the Michigan sales tax as to contend that admissions and telephone services constitute exemptions. It must be repeated, therefore, that the scope of the tax base of a sales tax law must be known first before exemptions can be distinguished from those receipts that are not taxable because they are not included in the tax base. A sales tax exemption exists

[2] Neil H. Jacoby, *Retail Sales Taxation,* pp. 104, 110.

when receipts that otherwise would have been taxable are definitely exempted. Because of the differences in the tax base of state sales tax laws, it follows that what is properly an exemption in one state may not be an exemption in another, although the same type of transaction is not taxed in either.[3]

Retail sales tax exemptions may take the form of outright exemption of designated classes of sales, refund of the tax after it has been collected on certain sales, or deductions from gross receipts permitted in the calculation of the tax liability of the retailer. Usually there is an outright exemption of certain sales and the retailer is not permitted to collect the tax from the buyer and is not required, therefore, to pay any tax to the state on such sales. Common examples of outright exemptions are sales to governmental agencies, religious and charitable institutions, and sales of gasoline subject to the motor fuel tax.

An example of an exemption effected by means of the refunding device is provided by the Arkansas sales tax law. A governmental agency may apply to the commissioner of revenue for refund of the tax paid on purchases of food for distribution to the poor or to public penal and charitable institutions. Hospitals and sanitoria may obtain a refund of the sales tax paid on all purchases.[4]

The method of allowing exemptions through deductions from gross receipts in the computation of taxable gross receipts is illustrated by the Michigan retail sales tax. Unlike the consumers' sales tax of some other states, the tax in this state is definitely levied upon the retailer and the law is silent as to whether he shall attempt to pass the tax on to the buyer; and if he does so, whether the tax shall be shown separately or merely included in the purchase price. The

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[3] See discussion of this point in Chapter I.

[4] Ark., *Act 154 of 1937,* sec. 16.

tax is 3 per cent of the retailer's gross receipts but certain deductions are allowed in calculating the amount of tax to be paid each month by the retailer. All exemptions here take the form of deductions in computing taxable gross receipts. Thus receipts from sales to the national, state, and local governments, sales to religious and educational institutions, and certain other types of sales are allowable deductions from gross receipts and are not taxable.

Classes of Exemptions

The existing sales tax exemptions are so numerous and diverse in character that it will be advantageous to group them for purposes of discussion. Exemptions may be classified in various ways, depending on the purpose of the classification. The same exemption may be included in a number of different classes of exemptions.

Exemption of Specific Commodities

All sales of specified commodities and services within a state may be exempt. For example, sales tax laws exempt schoolbooks in West Virginia, newspapers and magazines in New Mexico, gold, electricity, gas, and water in California, and milk, corn meal, flour, salt fat backs, sugar, and coffee in Alabama.

Exemptions Depending on the Use of Goods

Instead of exempting all sales of particular goods regardless of their subsequent disposal, the exemption often depends on the *use* to which they are put. The California sales tax exempts food for human consumption, so if a piece of meat is bought for the family dinner it is exempt, but if it is purchased to feed the dog it is taxable. The customary provision of sales tax laws that sales for resale shall be exempt frequently results in some fine distinctions

as to what constitutes a sale for resale, and the latter often depends upon the use of the goods sold. In some instances sales tax administrators have promulgated rules fixing a certain percentage of the amount received from certain sales that shall be exempt because part of the commodity sold will later be resold. The California sales tax regulations include the following with respect to the sale of baby chicks: [5]

> Where baby chicks or poultry are sold before the sexes are separated to a purchaser who buys them with the intention of retaining the pullets for the purpose of producing eggs and of selling the cockerels, the tax applies to the gross receipts from the sale of forty per cent of the chicks or poultry. The purchaser may give a resale certificate for the other sixty per cent.

In the same state gross receipts from the sale of fertilizer are not taxable if the products from the land upon which the fertilizer is applied are to be resold. Thus if a man buys fertilizer for his lawn or garden the sale is taxable but if he sells vegetables or flowers from his garden the fertilizer is exempt.[6] The taxability of sales of seeds and feeds depends on whether they are to be used to produce food for human consumption.[7]

> Gross receipts from the sale of seeds to persons who will use the products raised from the seeds as feeds are not taxable: (a) if the feed will be used for the production of food for human consumption; (b) if the purchaser is engaged in the business of selling dairy, poultry or livestock products.

Another group of exemptions arising from the *use* of goods consists of materials and supplies used in manufacturing or industrial processing. As the finished article is

[5] Cal. State Board of Equalization, *Sales Tax Rules and Regulations*, Ruling No. 3, February 18, 1936.

[6] Cal. State Board of Equalization, *Sales Tax Rules and Regulations*, Ruling No. 22½, Jan. 1, 1934.

[7] Cal. State Board of Equalization, *Sales Tax Rules and Regulations*, Ruling No. 56, March 9, 1938.

taxable when sold, there would be a pyramiding of the tax if the various sales of the materials used in producing the finished goods were also taxed. Consequently most of the retail sales tax laws allow exemptions of material used in industrial processing. The usual rule is that if the sale is to be exempt, such materials must become an "integral and component part" of the product manufactured. Where this is the case the sale of machinery and equipment used in manufacturing is taxable, but the sale of coal, electricity, and oil consumed in the process of manufacture may be exempt.

A much broader exemption is given by the Michigan sales tax act, which was amended in 1935 to exclude from the definition of "sale at retail" sales of tangible personal property "for consumption or use in industrial processing or agricultural producing."[8] This greatly increased the amount of sales in the exempt class since it exempted sales of machinery, tools, equipment, etc., used in industrial processing or agricultural production. The courts have held, however, that the amendment does not exempt *all* sales to industrial processors and agricultural producers, as this would have rendered the act unconstitutional.[9] To comply with the judicial interpretation of the amendment, the Michigan sales tax regulations divide manufacturing, producing and processing into three parts: administration, production, and distribution. The tax applies to the sale of all items which are to be used in "administration" and "distribution" but does not apply to sales of any items to be used exclusively in "production." Gross proceeds from sales of tools, dies, patterns, machinery used in the process of manufacturing, lubricating oil for use on the machinery,

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[8] (Michigan, *Act 77, 1935,* amending *Act 167 of 1933*).

[9] *Drake Printing Co.* v. *Michigan,* Circuit Court for the County of Wayne, Sept. 9, 1937.

and coal, gas, electricity or fuel oil used to operate machinery used in manufacturing are not taxable. But sales of tangible personal property for other divisions of a manufacturing establishment, such as the general accounting department or the sales department, are taxable. A similar procedure is followed in Ohio.[10]

The administrative problems encountered in Michigan in deciding what sales to industrial processors and to farmers are taxable and which are exempt have multiplied many fold since the enactment of the amendment liberalizing the scope of exemptions to these groups. Now other groups, particularly merchants, are protesting that they likewise should be exempt on their equipment. Logically, if machinery used in manufacturing or farming is exempt from the sales tax, there is a precedent for exempting sales of cash registers, show cases, and other equipment used by a retailer in his business as is done in Ohio.

Exemption of Commodities Subject to Special Taxes

Another group of exemptions consists of those granted in certain cases in recognition of the existence of other taxes imposed on commodities. Gasoline, tobacco, and alcoholic beverages are the commodities most commonly exempted from the sales tax when special excises are imposed. Since the excises constitute a considerable portion of the selling price, it apparently is assumed that these commodities should not be subject to the additional taxation of the sales tax. Gasoline upon which the state motor fuels tax has been paid is exempt from the sales tax in 15 states. In certain other states, such as Michigan and Illinois, gross receipts from sales of gasoline are taxable but the state motor

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[10] Mich. State Board of Tax Administration, *General Sales Tax Rules and Regulations,* as amended June 1, 1938, pp. 8–10.

Ohio Tax Commission, *Sales Tax Law Regulations and Special Rulings,* issued Jan. 1, 1937, pp. 21–24.

fuels tax is first deducted to compute the taxable gross receipts.

The federal gasoline tax, however, is not permitted to be deducted by retailers of gasoline, on the theory that this is already a part of the price when the gasoline reaches the retailer. Where the state gasoline tax is permitted as a deduction, presumably this tax is not regarded as part of the price, and collection of the sales tax on the full purchase price paid by the consumer is objectionable as it would be "levying a tax on a tax." To be consistent, however, the federal gasoline tax also should be an allowable deduction.

As a rule sales tax laws do not allow deductions for federal taxes paid. The New Mexico sales tax act, however, provides that all federal taxes on the product sold, except stamp and income taxes in any form, may be deducted in computing taxable gross receipts.[11] In Wyoming all commodities bearing a federal excise tax in excess of 20 per cent or a state excise tax in excess of 5 per cent are exempt from the sales tax.[12]

The popular notion that there is something particularly inequitable about levying "a tax on a tax" is evidence of lack of understanding of tax incidence. If consistently applied it would mean that the sales tax should not be imposed on that part of the selling price of *any* commodity which consists of taxes of any kind that have become a part of the price. Of course such a policy in sales taxation would present a preposterous task in administration. The theory underlying the exemption of gasoline from the sales tax particularly merits scrutiny. If the gasoline tax is regarded as a benefit tax and the revenue is spent on highways, the group paying this tax already should be getting "value re-

[11] New Mexico *Laws of 1935,* Chap. 73 as amended by Laws of 1937, Chap. 192, sec. 210.

[12] Wyoming *Laws of 1937,* Chap. 102, Sec. 4 (a), and sec. 6.

ceived" from their use of the roads and streets. Motorists along with other groups still have the obligation to help support the general services of government. If consumers as a class must pay a sales tax to provide revenue for such things as relief and schools, it would seem that expenditures for gasoline, including the gasoline tax, constitute as much a part of their "consumption" as any other expenditure.[13] If the payment of the gasoline tax warrants the exemption of gasoline from the sales tax, is it not fully as logical to contend that the portion of a man's income spent on gasoline should be exempt from the income tax?

The case for exempting from a general sales tax such commodities as tobacco, beer, and liquors when these are subject to special taxes is somewhat different, since the revenue from these taxes, unlike the gasoline tax, is not spent for the special benefit of the users of tobacco or liquor. Even here, however, it should not be presumed that exemption from the general sales tax is warranted merely because some other tax is being paid. It could be argued as cogently that property owners should be exempt from the sales tax as they pay the property tax, or income tax payers ought to be exempt because they are caught by the income tax. If it is believed that the taxes included in the price of tobacco and liquor—and this means not only state excises but also federal and any other taxes—would be too great if these commodities were subject to the sales tax, it would seem more logical to reduce the special excises than to exempt such commodities from the sales tax.

Each additional exemption adds to the complexities of the administration of the sales tax, narrows still further the tax base, and encourages pressure for other exemptions. If the sales tax is believed to be a proper source of public revenue on the ground that it is a tax on the broad base of con-

[13] Cf., Neil H. Jacoby, *Retail Sales Taxation*, p. 108.

sumption, it should be regarded as a tax in addition to all other taxes. This means that some other tax is not to be treated as being "in lieu" of the sales tax.

Exemptions of Sales to Specified Classes of Buyers

There is an important group of sales tax exemptions where the basis of the exemption is the status or nature of the buyer of products that would be taxable if sold to others. We may distinguish between the exemptions to public agencies and to private buyers. Sales to the United States Government are exempt on constitutional grounds. Slightly more than half of the sales tax states exempt sales to the state, and most of these also exempt sales to their political subdivisions. The exemption of sales to public agencies is customarily granted on the ground that to collect the tax on such sales would be "taking money out of one pocket and putting it in another" and therefore is an unnecessary and useless expense. It is questionable, however, if there is any saving in administrative trouble and expense provided the proper precautions are taken to insure that the exemptions do not lead to evasion of the tax on other sales which are taxable. The keeping of adequate records of exempt sales may itself entail more trouble than collecting the tax and requiring public agencies to pay for purchases on the same basis as other customers.

The plea that collecting the tax on sales to public agencies merely transfers money from one governmental pocket to another, has some cogency so far as sales to the state are concerned, but is not necessarily true with respect to sales to political subdivisions. When the latter are exempt from the sales tax it is in effect an unbudgeted subsidy, or a grant of an indefinite sum from the state. In view of the large aggregate volume of sums spent on purchases by counties, cities, school districts and other subdivisions, this subsidy

is not a small one. If the state collected a sales tax on all these purchases and used the additional revenue for grants-in-aid, it is not likely that the grants would be apportioned on the basis of the relative amount spent for purchases by the various local units. Consequently it is not a question merely of passing funds from the right hand to the left. The real reason, however, for not favoring exemptions to public agencies is that such exemptions add a further complication to a tax that at best is apt to be a maze of administrative complexities.

Traditionally in this country religious, charitable, and educational organizations and institutions not operated for profit have been exempt from taxation. It is not surprising, therefore, that they are exempt from about half of the state sales taxes. Where these exemptions are granted they constitute a form of subsidy to such organizations and institutions that is usually condoned on the ground that they perform a public service. Since tax exemptions to educational, philanthropic and religious organizations are discussed in another paper presented on this program, it will be superfluous to discourse here on the propriety of exempting these organizations from the sales tax. It is in order to point out, however, that the existence of these exemptions offers an excuse for pressure from benevolent, fraternal, and similar organizations to obtain tax subsidies. The Michigan law exempts sales to legally incorporated benevolent, charitable and scientific institutions of learning, in addition to the exemption granted to religious and educational institutions.[14] Despite repeated attempts to claim sales tax exemption on purchases by benevolent and similar organizations, sales tax administrators in this state have consistently refused to widen the breach and have insisted upon a strict interpretation of the law. This means that only benevolent, chari-

[14] Michigan, *Acts of 1933*, No. 167, sec. 4 (c).

table and scientific *institutions of learning* are entitled to the exemption.

Exemptions Depending on the Type of Seller

With the exception of those states having a sales tax with two or more rates and applying different rates to various classes of sellers, as in Arizona or Indiana, the sales tax usually applies only to sales made at retail. Thus wholesalers and other vendors selling goods intended for resale by the purchaser are generally exempt from the tax except when they make sales at retail. Similarly, casual and isolated sales are usually exempt from the sales tax, since the tax is customarily limited to sales by sellers doing a regular retail business.

Farmers ordinarily are exempt on most of their sales, since normally their products are purchased for resale. Some farmers, however, operate roadside stands, peddle their produce from house to house, or in other ways sell directly to the consumer. In some states such sales are taxable as sales at retail. In Ohio food is exempt from the sales tax provided it is not consumed on the premises of the vendor. Thus if a farmer sells a watermelon, or some other food product, that is eaten at the farm or his roadside stand the sale is taxable, but if the melon is taken away to be consumed elsewhere the sale is exempt from the tax. It is safe to venture the opinion that sales tax administrators must have a lively time attempting to collect the tax from farmers where some of the sales of the latter are legally subject to the tax. In several states the sales tax law specifically exempts all sales of livestock, poultry, and agricultural and horticultural products when sold by the grower or producer. This exemption common in the sales tax laws of predominantly agricultural states, may reflect the political influence of farmers in these states, or it may be a

frank recognition of the almost insuperable task of the effective collection of the tax from farmers on their retail sales.

Another type of seller sometimes exempt from the sales tax is the publicly owned enterprise engaged in making sales that would be taxable if made by a private vendor. Although sales tax laws often grant exemption from the tax on sales *to* the state and its subdivisions, they are usually singularly silent on the question of the taxability of sales *by* a governmental agency. Thus the Michigan sales tax act contains no mention of the exemption of sales by the state and its political subdivisions. Nevertheless the courts have held that sales of electricity and water by a municipally owned utility are not taxable.[15] Furthermore, sales of goods and equipment such as refrigerators, stoves, and light bulbs and fixtures by a publicly owned utility are exempt. Such goods are sold in competition with private retailers who are subject to the sales tax. Not only the question of unfair competition may be raised, but there is unfairness to consumers of private utilities when those of publicly owned plants do not have the sales tax added to their bills. In effect consumers of municipally owned utilities are being subsidized. There seems to be no sound reason to justify this discrimination, except that the courts have said that the exemption must be given.

Sales by the state liquor stores of Michigan and also those of certain specially designated private distributors of liquor who are deemed agents of the state liquor control commission are exempt from the sales tax. Sales of liquor and beer by all others selling at retail, however, are taxable. The policy of some of the other states, such as Indiana, of levying the sales tax on the gross receipts of governmental en-

[15] *Wyndotte* v. *State Board of Tax Administrators,* 278 Mich. 47 (1936).

terprises as well as upon private enterprises of the same nature seems more sensible.

EXPLANATIONS OF THE EXISTENCE OF EXEMPTIONS

The reasons for the various types of sales exempted will not be found in the sales tax statutes. Only observation of the forces at work, often behind the scenes, will explain why a legislature authorizes the exemptions it does. We know that the primary reason for the existence of many sales tax exemptions has been the political pressure of groups demanding the tax subsidy.

Some sales must be exempt because the state has no authority to tax them. For constitutional reasons sales to the federal government and sales in interstate commerce are exempt. An interstate sale of goods to be used in another state is not taxable by the state of the seller, but goods purchased from a vendor in another state may be subjected to a use tax. In legal phraseology the use tax is a tax upon the use, consumption, or storage of tangible personal property after it has come to rest within the state and has ceased to be a transaction in interstate commerce. The use tax, therefore, is a device whereby the constitutional requirement for the exemption of sales in interstate commerce may be partially circumvented.

State constitutions usually have been neither a bar to the granting of exemptions by the legislature, nor have required particular exemptions. The first Illinois sales tax law, however, was declared unconstitutional because certain exemptions granted were held to violate the uniformity provisions of the state constitution.[16] As a consequence these exemptions were eliminated when the present Illinois sales tax law was enacted.

Many sales tax exemptions not specifically stated in the

[16] *Winter* v. *Barrett*, 352 Ill. 441.

law arise from the interpretation given to the law by the state agency administering the sales tax, the attorney general, and the courts. Sales tax laws, like any others, are sometimes poorly drafted so that the coverage of the tax is not precisely defined. Even a carefully worded act requires interpretation as to what sales are taxable. Some exemptions exist which may not have been intended by the legislature but which are the result of interpretation of the law. For example, whether a sale is taxable may depend on the interpretation given to the phrase "tangible personal property." In several sales tax states the sale of electricity is taxable. The Illinois law taxes sales of tangible personal property at retail and does not specifically exempt sales of electricity. However, in that state the courts have held that public service companies furnishing electricity are not engaged in the business of selling tangible personal property.[17] This decision removing the tax from sales of electricity probably would not have occurred if the Illinois law had contained the following definition of tangible personal property found in several sales tax laws:

> The term "tangible personal property" means personal property which may be seen, weighed, measured, felt, touched, or is in any other manner perceptible to the senses.[18]

The primary purpose of some exemptions is to facilitate the administration of the tax. Tax administrators themselves may recommend certain exemptions on the ground that the revenue collected from certain classes of sales would not be worth the trouble and expense of attempting to collect it. For example, it may cost more to force farmers to pay a sales tax on such retail sales as they make directly to consumers than the amount of revenue obtained. In such cases, there is some excuse for the exemption on fiscal

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[17] *People's Gas Light and Coke Co.* v. *Ames,* 359 Ill. 152.

[18] Cf., Wyoming sales tax law, *Laws of 1937,* Chap. 102, sec. 2 (1).

grounds, provided it does not stimulate evasion on taxable sales or necessitate too much additional expense in checking and reporting exempt sales. The fiscal argument for exemptions, however, is very easily overworked. In general, tax administrators have found that an exemption is more likely to complicate than to facilitate administration of the sales tax.

A few states grant what may be called a lump-sum or minimum exemption to sellers. Under the Indiana gross income tax a retailer is entitled to an annual exemption of \$3,000 of his gross income from the tax, and in Michigan the taxpayer may deduct \$50 per month or \$600 a year from his gross receipts in computing the amount of tax. The reason advanced to justify this type of exemption is that it is an attempt to compensate the seller for his "cost of compliance" with the tax law. The seller has the trouble and expense of keeping records, making periodic reports, and must pay the tax on his gross receipts regardless of whether he has been able to shift the tax to his customers. It is argued, therefore, that since in effect he is serving as a tax collector for the state, the exemption of a stated minimum amount of his gross receipts is only just compensation for services rendered to the state.

Although there is some truth to this contention, it should be pointed out that the amount of "compensation" bears no necessary relation to the actual cost of compliance. In Michigan the deduction from gross receipts results in a reduction of \$18 a year in the amount of sales tax paid by each vendor regardless of the difference between sellers in the size and nature of their sales, the total cost of compliance, or success in shifting the tax. This necessarily means that some vendors are "compensated" less than others in proportion to their actual cost of compliance. Furthermore, it is appropriate to ask why retailers should be allowed a

minimum exemption from the sales tax as compensation for their cost of compliance when it is the prevailing practice not to allow exemptions for this purpose in the case of other taxes. Vendors who are in effect serving as collectors of the gasoline tax, liquor, tobacco and other taxes are allowed no compensation for cost of compliance. They must accept this as part of the cost of doing business and obtain their "compensation," if possible, through the prices obtained for their products.

Another type of minimum exemption is that allowed to consumers on sales of less than a stated number of cents. The consumers' sales tax of Ohio exempts sales where the price is less than eight cents, and that of West Virginia exempts sales of five cents or less. When sales tax tokens are not used the tax on an individual sale could not be less than one cent, and if this were collected on a five cent sale it would be a tax of 20 per cent of the purchase price, a much higher rate than on larger purchases. The use of tokens obviates this difficulty and circumvents the excuse of exempting small sales. The use of tokens can be such a nuisance, however, that it may be more expedient to exempt sales of less than a specified number of cents. Logically, such sales should be taxable and at the same rate as other sales, but the advantage of achieving this result may not be worth the cost and trouble.

Another purpose in allowing sales tax exemptions is to make the tax more equitable, or perhaps we should say to render it less inequitable. Some exemptions are usually given to avoid unfairness to the retailer. When goods previously sold are returned to the dealer by a customer, if he remits the full amount paid, including the sales tax, the dealer is allowed an exemption from the tax on the previous sale of such returned goods. In reality there was no sale and it would be inequitable to hold the seller responsible for

paying sales tax on goods that he did not sell. Likewise there is usually some provision in sales tax laws with respect to tax liability when goods are sold on credit and the dealer fails to receive payment. There is considerable diversity in the practice of different states with respect to credit sales. Under the California law the vendor must pay the tax on such sales regardless of whether he is able to collect from the customer. In Mississippi the seller may take credit on his sales tax return for bad debts actually charged off where taxable sales were made on credit. In Michigan the taxpayer may apply to the sales tax administrator for permission to pay the tax on credit sales when payment is received. The Illinois law provides that gross receipts shall be taxable only when payment is made for the goods sold.

A type of exemption the purpose of which is greater equity to consumers, is the exemption of food in order to reduce the regressive effects of the sales tax. As families in the lower income groups spend a larger proportion of the budget for food, the exemption of food materially lessens the amount of sales tax they bear. The exemption of food —as in California, Ohio, and a few other states—has much to commend it to the economist, since it does reduce considerably the regressivity of the sales tax. From the standpoint of the effects upon the administration and the yield of the tax, however, the exemption of food sales is inexpedient. When this exemption is allowed it brings with it many additional headaches to sales tax officials. Numerous decisions must be made as to whether particular items shall be considered as food. Since a retailer selling food also usually sells other things which are taxable, there must be special care in checking and auditing to insure against evasion by reporting as sales of food some sales that are taxable.

The exemption of food is also of very great fiscal importance. Statistics compiled by the State Board of Tax Ad-

ministration show that if sales of food were exempt in Michigan the yield of the sales tax would be reduced 25 per cent. This would mean a loss in revenue of about $13,000,000 annually. Most of the sales tax states have been too hard pressed for revenue to be willing to exempt sales of food for human consumption. The desirability of this exemption depends upon whether one thinks the advantage of reducing the regressivity of the sales tax outweighs the disadvantages of obtaining from other sources additional revenue equivalent to the amount lost by exempting food, and the administrative problems the exemption would entail.

In conclusion, it appears probable that in many states there will be more, instead of fewer, sales tax exemptions. The need for revenue has been the principal check on widening the exempt field, but this has been inadequate defense against pressure for additional exemptions. There is pressure on sales tax administrators for more liberal interpretations of the law, litigation to obtain exemptions by court decisions, and demands for legislative amendments giving further exemptions. Once an exemption has been obtained it is not likely to be rescinded by the legislature. Political expediency, rather than logic, greater equity, or administrative advantage, may be expected to be the prime consideration in bestowing tax subsidies through sales tax exemptions.

CHAPTER XI

EXEMPTION OF TANGIBLE PERSONALTY

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The evolution of the assessment and taxation of tangible personal property is a part of the history of the property tax generally. In the pre-revolutionary period, taxes on such personal property were applied only to the specifically enumerated items of property at statutory valuations. In the succeeding period up to the time of the Civil War, the general property tax became the backbone of the state and local revenue systems, and the principle of strict uniformity of valuation and taxation was the basis for the administration of the ad valorem tax.

In the emphatic words of the Illinois Joint Legislative Revenue Committee: "Those sections of the state constitution requiring that all property be taxed uniformly in relation to value impose a taxation system which is economically unsound, impossible of administration and politically debasing in its effects."

Since the Civil War, economic, social and governmental conditions have undergone extensive changes. The accelerated divergence of personal property and especially the multiplication of kinds and forms of intangible personalty have been the primary causes of the movement for state constitutional provisions for the classification of personal property for purposes of taxation. The outstanding practical effect of these provisions has been the official classifica-

tion, with preferential treatment of intangible personalty and, to a more limited degree, of some classes of tangible personalty.

While the revenue provisions in state constitutions and in the statutes place the duty of reporting all personal property on the property owners, and the responsibility for assessment of all such property on assessing officials, it is only within recent years that increasing attention has been given to the development and application of sound procedures and standards for use both by assessing officials in determining equitable assessments and for reference by property owners in reporting the personal property subject to the ad valorem tax. Substantial advances have been made in some jurisdictions in the procedures and techniques used in the assessment of personal property.

At the same time, there has developed the tendency and practice in an increasing number of jurisdictions to provide either full or partial property exemption from the ad valorem tax. Such exceptions are being allowed either under specific statutes or through the more common practice of debasement, undervaluation, or omission, of certain classes and types of property.

Extent and Types of Personal Property

Accurate data are not available on the actual or relative totals of tangible personalty in the country or of the value of all personal property which is assessed and exempted.

Some approach to the relative percentages of assessed values of real property and personal property may be obtained from statistical comparisons of tax rates and assessed values in 294 cities in 1938 as prepared by the Detroit Bureau of Governmental Research. These are published in the December, 1938, issue of the *National Municipal Review.*

Of the total of 276 American cities of over 30,000 population which furnished the 1938 statistics on the above, some 40 cities, or 15 per cent, reported no personalty assessments. The percentages of personalty assessments to the total real and personal property assessments in the reporting cities varied from zero per cent in the case of 40 cities up to approximately 45 per cent in the case of the City of Baltimore. Ninety-two per cent, or 254 of the 276 cities, had personal property assessments which were less than 30 per cent of the aggregate property assessments in the respective cities. Approximately 65 per cent, or 180 of all reporting cities, had personal property assessments which were under 20 per cent of the aggregate property assessments. Roughly, the median per cent of total property assessments as represented by personalty was about 15 per cent in these reporting cities.

The above comparative data roughly reflect the wide variations in the assessment, exemption, and omission of personalty from taxation. They also point out the peaks and valleys of assessed values relative to full cash values.

For purposes of taxation, personal property is usually defined residually as all property other than real property, the broad distinction between real and personal property being that personal property is movable. All types of personal property are in turn classifiable as either tangible or intangible personalty.

The several classes of tangible personalty have frequently been listed under basic types according to physical similarities. These types have in turn been grouped as either productive or non-productive on the basis of use and incidence of tax. The grouping of all tangible personal property on the basis of these two major classifications is as follows:

Non-Productive Tangible Personalty

Household furniture and furnishings
Personal effects
Passenger automobiles

Productive Tangible Personalty

Trucks and busses
Livestock
Farm machinery and equipment
Office and store furniture and fixtures
Merchandise and goods on hand and in process
Manufacturing machinery and equipment

Household furniture, furnishings, personal effects, and passenger automobiles are ordinarily purchased for personal use and do not yield any income to the owners. Property taxes on such unproductive personal property are not shifted, as there are usually no price transactions subsequent to the imposition of the original tax. On the other hand, the various items of productive tangible personalty are purchased, possessed, and used for purposes of profit or productiveness; and property taxes on such productive personalty are shifted.

Present Exemptions of Tangible Personalty

As far as available data on trends of tax exemption of tangible personalty are concerned, the facts appear to be reasonably clear. The tax policies and trends in the jurisdictions having advanced assessment and tax administration suggest the lines along which development of a sound tax system might proceed and, to some extent, the desirable limits of tangible personalty exemption.

In the examination of the soundness of exemptions of tangible personalty it is helpful to review the present exemption provisions in the state laws relating to the assessment and taxation on such property. The variations among

the exemption provisions and features are so numerous as to make generalizing extremely difficult.

The clearest country-wide development and trend is in the full or partial exemption of household furniture, furnishings, and personal effects. Nine states now grant full tax exemption of household furnishings and personal effects, while 29 states provide for the exemption of initial amounts varying from $50 to $1,000 of household furnishings or of personalty in general. It is of interest that of those states granting full exemption, the four industrial states of New York, Ohio, Pennsylvania, and Wisconsin are included.

Ten states, most of which still operate under the constitutional general property tax, provide for no official exemptions of tangible personalty as a class. Examination of the general practice and custom in a large number of assessment jurisdictions, however, points to general tax exemption either through debasement, undervaluation, or omission, of such personalty from the assessment roll.

A total of 17 states have substituted various forms of motor vehicle registration taxes in lieu of the ad valorem property tax on passenger automobiles and other rolling equipment. In most of these states privately owned and operated motor vehicles are subject to a state registration tax based on weight, horsepower, or carrying capacity. Such motor vehicles in many other states are subject to the state registration tax and occasionally to local license taxes, in addition to the ad valorem tax.

Statutory exemptions have been provided in approximately one-third of all the states for certain classes of tangible personalty used in agriculture. The classes of such agricultural personalty which are exempted from the property tax include initial amounts of certain types of livestock,

farm equipment having values below specified amounts, and farm crops which are in the hands of farmers.

The most prevalent type of exemption affecting tangible personal property used in business is that permitting temporary exemption of newly located or newly constructed plants, and the machinery and equipment in such plants. Such statutory provisions are to be found in 16 states, most of which are in the South.

Several states also permit extensive exemptions of tangible personalty in established industrial enterprises as well as in newly located plants. Such personalty is entirely exempt from the ad valorem tax in the states of New York, Delaware, and Pennsylvania. The state of Massachusetts, in effect, taxes such industrial personalty by means of excise taxes. Raw materials, tools, machinery, and finished products of manufacture in Missouri are exempt where the value does not exceed $1,000. These same personalty items may be exempted by Maryland counties and such exemptions continue until specifically repealed by the Maryland state legislature.

Partial exemptions of industrial and business tangible personalty are granted in several other states through reduced assessment ratios or through lower tax rates. The Ohio tax laws provide for a lower assessment ratio, while the Kentucky laws provide for lower tax rates for such properties. Minnesota, Montana, and West Virginia laws provide varying assessment ratios and tax rates for various classes of personalty, but tangible personal property used in business does not receive preferential treatment.

Some 24 states have statutory provisions retaining the general property tax, and tangible personal property used in business is required to be taxed on the same assessment base and tax rates as real property. Among these 24 states

are the populous and industrial states of Illinois, Indiana, Michigan, and New Jersey.

The diversity reflected in these statutory exemptions, and in exemptions through usual assessment practice, is as needless as it is objectionable. Variations in most of the statutory provisions dealing with the assessment and taxation of tangible personalty are overemphasized. The statutory requirements are generally leveled off through actual practice in most assessment jurisdictions.

Experience has shown that substantial uniformity in exemption as well as in the assessment of basic classes of tangible personalty is entirely practicable. The general approach toward such uniformity has been presented in the reports of at least two committees of the National Tax Association on model systems of state and local taxation. Uniform dates, uniform methods of valuation, and general uniformity in the taxation of tangible personalty are outlined in such reports.

Criteria for Judging Property Tax Exemptions

The general tax policies and trends indicate outstanding criteria for property assessment and exemption and also suggest the lines along which development of a sound tax system should proceed. Such policies require the provision for an integrated revenue system which will produce the required revenues for essential governmental needs, a revenue system that is simple and inexpensive to administer, a system that appeals to the majority of citizens and taxpayers as being fundamentally just and impartial, and that is sufficiently broad in application so as not to overburden the various elements.

A tax system having the above characteristics must necessarily be made up of a number of different types of taxes. Each type of tax should add to the integrated system of

which it is a part some of the desirable characteristics, without more than offsetting objections. Theoretically, such a model tax system is aimed to measure the benefits received by and the ability of each individual and business establishment to contribute to the necessary public services.

Various criteria have been advanced in connection with property tax exemptions. These are helpful in the determination of the soundness of exemption of certain classes of tangible personal property. The following criteria and bases for judging property tax exemptions are summarized from the article on this subject in the Encyclopedia of the Social Sciences:

1. Social and political distinction and pressure;
2. Encouragement of certain economic and business activities;
3. Encouragement of socially desirable activities;
4. Avoidance of taxation of the same item under more than one tax;
5. Protection of the minimum subsistence of individuals;
6. Avoidance or reduction of administrative difficulties involved in discovering and assessing certain items of property and in the administration of tax collection services.

The first three of the above criteria are either not directly applicable, or are considered as unsound bases for exemption of tangible personalty as a class. The second three criteria have some logical support for tax exemption of specific types of tangible personalty. These criteria for the exemption of certain types of property do not, of course, constitute a formula or absolute rule for measuring the wisdom of exemptions. Opinion and subjective judgment admittedly play a part in the application of these concepts to specific taxes. Many situations exist, however, where the basis for objections to the property tax has been confused with criticism of tax administration. In some instances, the objectionable features and administrative difficulties are overstated. The extent of exemption of any forms of tangible personalty should be determined both by analysis of

the above criteria and of the tax-bearing relationships of the specific properties and by actual experience.

Exemption of Household and Personal Effects

As a matter of principle and good practice, exemption should be provided only for such classes of tangible personalty as are unproductive in character and to which sound criteria supporting exemption actually apply. These include such tangible personalty items as household goods and furnishings and personal effects.

The complaints of administrative difficulties involved in connection with the assessment and collection of taxes on these items are well known. These include such problems as the difficulty in tracing and discovering the various items falling under these classes; the difficulty of uniform valuation of the different kinds, sizes, and qualities of such personalty; the tax collection difficulties because such property is moved or is exempt from attachment or restraint; the general public antipathy toward what is considered to be a meddlesome invasion of the home to discover such property; and the resulting high administrative costs in relation to taxes actually collected from such sources.

Though devices and methods have been developed to reduce administrative difficulties, the fact that such problems and difficulties do exist and weigh heavily on the taxpayers compared with other taxes has been and should be the primary basis for exemption of household furnishings and personal effects from the ad valorem tax. This tax policy is in line with the general trend for exemption of household goods and personal effects, particularly in initial amounts. As a matter of principle and following through to a logical conclusion, all household furnishings and personal effects should be entirely exempted from the property tax.

Exemption of Passenger Automobiles

Similar to household furnishings and personal effects, passenger automobiles which are used for personal convenience do not yield income to their owners. In comparison with household and personal effects, passenger cars do not offer nearly the extent of administrative difficulties in discovery and assessment. The only logical basis for exempting automobiles not used in business is that they are subject to other forms of taxation which are more equitably and easily determined and collected.

Practices in different states throughout the country suggest that the motor vehicle registration tax is a more effective and forthright method of taxation than the ad valorem tax. Such motor registration tax is graduated directly in relation to weight and horsepower.

Tangible Personalty Used in Agriculture

The tax-bearing characteristics of tangible personalty used in agriculture are similar to those of tangible personalty items used in business. Such items as farm equipment, livestock, and crops yield income to the owners; and taxes on these items are passed on eventually to the consumers.

Any general exemption of farm equipment, livestock, and crops constitutes a poorly organized subsidy to agriculture. Such classes of property should be assessed on fair and equitable values and taxed at the effective rates applied to real property and industrial tangible personalty.

Tangible Personalty Used in Business

From the points of view of the public benefits to property and of capital outlays by entrepreneurs, there is no distinction between tangible personal property and real estate used in connection with industrial or mercantile enterprises.

Machinery, tools, equipment, fixtures, stocks on hand, and work in process, which are in the possession of either manufacturers, distributors, or service enterprises, are all productive and over a period of time the property taxes on them are shifted to the consumers.

As indicated under the discussion of the present state laws with regard to property exemptions, approximately one-third of the states, most of which are in the South, now exempt the real estate and tangible personal property of newly located manufacturing concerns from the ad valorem tax during initial operating periods of from three to ten years.

The experience in those states which provide initial period exemptions to manufacturing is that enterprises of permanence are not greatly influenced by such temporary concessions. Furthermore, the encouragement of business either by official or unofficial, partial or complete, exemption of newly located industries during such initial periods amounts to poorly organized subsidies to such enterprises. Encouragement for locating and extending new business enterprises should be brought into the open and, where the communities find it economically wise and necessary, such assistance should be in the form of outright subsidy, definitely separated from property assessment and taxation. Assessment administration should be recognized as a distinct public function which is necessary to determine on factual bases the fair and sound value of property for tax purposes.

For the reasons indicated, all tangible personal property used in manufacture and in business should be assessed and subject to the same effective tax rates as real estate.

Significant progress has been made where the assessing officials have developed and have uniformly applied practical standards for the valuation of inventories, machinery,

equipment, and other classes of tangible personal property. These include determinations as to market and cost values, the extent of physical depreciation, obsolescence, and price and economic conditions and other factors affecting value and utility. The consolidation of local assessment jurisdictions and the extension of the practice in use in several states whereby the state tax commissions cooperate with the local assessors and, upon request, furnish assistance in the assessment of unusually difficult types of property, also add greatly to uniformity and high quality of property assessments at relatively low cost to local assessment jurisdictions.

These satisfactory results are being obtained in determining equitable assessments on industrial and business tangible personalty in an increasing number of localities and these are being accomplished with decreasing administrative difficulties.

Under existing revenue and fiscal requirements throughout the country, the taxes on productive classes of tangible personalty must continue to be an essential component part of a sound revenue system, in no less measure than real property. Reduction of the tax load on such properties as well as on real estate, must be obtained through establishment of a closer relationship of the governmental benefits received by and income derived from each of the properties as compared with the total revenues from the various tax sources.

Summary

Different levels of exemption on certain classes of tangible personalty are now granted in various jurisdictions. Such full or partial exemptions are made both through specific statutory provision and through general assessment practice and usage. In certain states, exemptions for similar prop-

erties having like tax-bearing characteristics amount to special temporary or full-time subsidies. The tendency is in the direction of greater personalty tax exemptions and the substitution of other types of taxes, such as sales and income taxes.

Administrative problems connected with the assessment of certain types of tangible personalty and with the collection of taxes on such personalty are generally exaggerated. Reduction in such administrative difficulties has been accomplished through application of sound valuation procedures and through businesslike assessment and tax administration.

Exemption of specific items of tangible personalty should be provided only after examination into the economic and tax-bearing characteristics of such items, and after determination that taxes on such items result in inequitable multiple taxation, serious administrative difficulties, or interference with minimum subsistence requirements.

In line with sound tax policy and the experiences in progressive assessment jurisdictions, certain items of tangible personalty should be entirely exempted from the property tax.

In the cases of household furniture and furnishings and similar personal effects, the assessment and collection of taxes are relatively difficult and expensive to administer. The ad valorem tax on such classes of property has incurred the special antipathy of property owners and taxpayers. As a matter of principle, all individually owned and used household furniture, furnishings and personal effects should be exempt from the ad valorem tax.

Personally used passenger automobiles should be entirely exempt from the property tax. They are now subject to other forms of taxes which are more equitably and easily determined and collected.

Satisfactory results are being obtained in determining equitable assessments on industrial, business, and agricultural tangible personalty in an increasing number of localities. The taxes on such productive classes of tangible personalty must continue to be an essential component part of a sound property tax system and should be assessed and be subject to the same effective tax rates as real estate.

There are interrelated problems, the working out of which will remove some of the major causes of variations in effectiveness in property assessment and tax administration.

To assure more equitable assessment of personalty and to clarify the bases for assessment administration generally, further extension and application of sound assessment procedures is imperative. These also tend to minimize inequitable and extra-legal exemptions and reduce or eliminate difficulties of administration of property assessment and tax collection.

Adoption of procedures and uniform standards of assessment and exemption along the lines indicated, and further improvement in property assessment administration and in the coordination of pyramiding taxes of the various levels of government, will materially reduce hazards of arbitrary assessments and exemptions and uncollectible taxes, will assure more effective and equitable tax administration, and will bring the property tax into line with sound tax policy and trends in this country.

CHAPTER XII

THE EXEMPTION OF INTANGIBLES FROM PROPERTY TAXES

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THE exemption of intangibles from property taxes seems to be a timeless subject. It has been discussed in practically every general treatise on taxation which has been published in the past fifty years, and will probably continue to be the subject of active debate, within the legislative chambers if not within the cloistered halls, for several more decades.

I think it may be wise to introduce this subject with some explanation of the term "intangibles." If by property we mean the brick, mortar, cement, wood, and plaster which make up a building, intangibles may mean one thing; but if we mean by property, as the lawyer professes to until he becomes a tax lawyer, the bundle of rights, privileges, and immunities which are enjoyed by persons holding interests in the building, it may mean quite a different thing. To define intangibles as all property that is not tangible, or all property which is incorporeal, is simply to dodge the issue. But rather than attempt a definition which would satisfy an Aristotelian logician, I propose to describe intangibles. They are of two general types: First, there are the legal and beneficial claims of one person on the assets or income of another; second, there are those indefinable assets which we designate by such terms as patents, good-will, copyrights,

trade marks, and special franchises. The accountant means the latter when he speaks of intangibles; the tax administrator, being essentially more broad-minded than the accountant, sometimes means both but usually means the former. We will refer to good-will and its colleagues as non-representative intangibles and to all other intangibles as representative intangibles.

This term "representative intangible property" will stand further explanation. I have made a rather hasty search of the literature for its origin and meaning. The adjective "representative" has been used to modify the nouns "wealth" and "property" for at least thirty years.[1] I believe it is fair to say, however, that Leland popularized, and to some extent formalized, the term in his *Classified Property Tax in the United States,* published in 1928. Leland proposed a division of intangibles into three classes—representative intangible property, non-representative intangible property, and a third, hybrid classification which was not specifically named—with a different tax policy for each class.[2] In making this three-fold classification, Leland apparently broke with earlier usage, for, so far as I can discover, Lyon [3] and Plehn,[4] and Lutz subsequently,[5] conceived of a true dichotomy, as, indeed, the terms "representative" and "non-representative" imply. I am also not at all convinced, as I shall subsequently indicate, that the three-fold classification is useful in the framing of tax policies. I am therefore dividing all intangibles into two categories, as previously stated. I define representative intangibles to include all property which is at once the asset of one person

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[1] *State* v. *Parmenter* (1908) 50 Wash. 164.
[2] Simeon E. Leland, *Classified Property Tax in the United States,* p. 119 ff.
[3] "The Taxation of Securities," *Proceedings of the . . . National Tax Association,* 1914, p. 221.
[4] *Introduction to Public Finance,* 4th ed., 1920, p. 185.
[5] *Public Finance,* 3d ed., 1936, p. 503.

and the liability of another, using the term "liability" in a broad sense (repugnant to my accountant friends) to include the obligations of a corporation to its stockholders.[6] It is of these intangibles, and not of good-will and franchises and patents, to which I refer throughout the remainder of this paper.

And, while we are on the subject of definitions, let me state that I mean by property taxes not only the general property tax, but also all substantially proportional taxes in lieu thereof.

What Intangibles May a State Tax?

I think it can safely be said that no state taxes, or even pretends to subject to the property tax, all of the representative intangible property within its jurisdiction.

In order to prove this it is hardly necessary to do more than enumerate the intangibles which a state may tax if it chooses to do so. Aside from the state constitution itself, which we will assume can be changed, there are but two limitations which the state faces in the taxation of intangibles. One is a natural limitation which is imposed by complete lack of jurisdiction over a debtor, his creditor, and the instrument, if any, which evidences the debt. Such a limitation would be faced by the state of Louisiana, where I have never been and perhaps never will be, if it were to attempt to tax me on a debt owed me by my brother, who has never been in Louisiana either. There would simply be no means of enforcing such a tax. Then there is the

[6] National Association of Assessing Officers, *Assessment Terminology*, 1937, p. 26. The only other actual definition which I have discovered is that given by Jensen in his *Property Taxation in the United States*, 1931, at page 41. In effect, he defines representative intangibles as those which diminish the rights or interests of others in particular goods. He then proceeds to classify accounts and bills receivable, judgments, and bank deposits as non-representative intangibles. Lutz, on the other hand, classifies mercantile credits, as well as stocks, bonds, and mortgage notes, as representative intangibles.

legal limitation imposed upon a state by reason of its membership in a federation of states operating under a federal constitution. While the Constitution of the United States does not state definitely what a state may subject to property taxation and what it may not, it has been interpreted by the learned justices of the United States to prohibit a state from taxing securities issued by, or under authority of, the federal government and from "importing" taxable values which clearly belong to other states, as when a state in which a debtor resides attempts to tax the creditor.[7] Somewhat akin to the latter limitation is the occasionally successful invocation of the Fourteenth Amendment to protect a taxpayer from double taxation by preventing one state from taxing intangibles which are taxable under more fully accepted principles by another state.[8]

But even after eliminating these intangibles from consideration, each state has a broad range of intangibles which are constitutionally available for taxation and taxes on which are subject to some, albeit often slight, measure of enforcement. These intangibles are included under the following heads:

1. Intangibles owned by residents of the state, including in the term "residents" resident individuals,[9] domestic corporations,[10] and resident individual or corporate trustees;[11]
2. Intangibles used in business in the state;[12]
3. The intangible assets of an estate when the letters of administration are granted by a court of the state;[13]

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[7] A state may, however, tax a nonresident on his mortgage interest in land within the state when the owner of the fee is taxed only on the excess of the land value over the amount of the mortgage. *Savings & Loan Society* v. *Multnomah County* (1898), 169 U. S. 421.

[8] *Safe Deposit & Trust Co.* v. *Virginia* (1929), 280 U. S. 83.

[9] *Blodgett* v. *Silberman* (1928), 277 U. S. 1.

[10] *Newark Fire Insurance Co.* v. *State Board of Tax Appeals* (1937), 120 N. J. L. 224. An appeal from this decision is pending before the United States Supreme Court.

[11] *Mackay* v. *San Francisco* (1900), 61 Pac. 382.

[12] *First Bank Stock Corp.* v. *Minnesota* (1937), 301 U. S. 234.

[13] *Tafel* v. *Lewis* (1906), 78 N. E. 1003; *Commonwealth* v. *Peebles* (1909), 119 S. W. 774.

4. The shares of national banks and of some—perhaps all—domestic corporations;
5. The beneficial interests of residents in some, but not all, nonresident trusts.

The last two categories are not very well defined. So far as national bank shares are concerned, the law is clear. By act of Congress, such shares may be taxed by the state in which the bank is located and by no other state. But the law is not clear as to the powers of a state to tax the shares of domestic corporations. Up until a few years ago, we thought that the state of domicile could tax such shares even though they were owned by nonresidents and even though the assets of the corporation were fully taxed by the state of domicile or by some one or more other states.[14] This assumption was questioned in *First National Bank* v. *Maine*[15]—an inheritance tax case. The Supreme Court held that the state of Maine could not lay an inheritance tax upon the shares of a Maine corporation owned by a nonresident decedent. No exactly analogous case has been decided in the field of property taxes and probably none will be, for the simple reason that states very seldom attempt to tax the nonresident shares of a domestic corporation except as an "in lieu" tax to compensate for the exemption of taxable assets of the corporation. If a corporation has assets within the state and the state chooses to exempt some or all of such assets, taxation of the shares (or of the so-called "corporate excess") is considered as essentially a substitute for taxation of the assets; hence the residence of the shareholder is immaterial. This is especially apparent when the shares are assessed only on the difference between their full value and the assessed value of such of the corpo-

[14] *Corry* v. *Baltimore* (1905) 196 U. S. 466; *Cream of Wheat Co.* v. *Grand Forks County* (1920) 253 U. S. 325.

[15] 284 U. S. 312 (1932).

rate assets as are taxed directly, although the deduction of directly taxed assets from the share value is not essential to the validity of the tax.[16]

The law governing the taxation of resident beneficiaries in nonresident trusts seems even more confused. While the primary rule of tax situs for trusteed intangible property is that the property is taxable at the residence of the trustee or at the business situs of the trust corpus, and that the interests of beneficiaries in the corpus are not separately taxable property,[17] exceptions have been made and will probably continue to be made. On the basis of a most superficial survey of the cases, it appears to me that a settlor may be taxed on his interest in a freely revocable nonresident trust [18] but that neither the settlor nor the beneficiaries may be taxed on their interests in a nonrevocable or not freely revocable trust held by a nonresident trustee.[19] However, in at least some states, *e.g.*, Pennsylvania, resident beneficiaries in nonresident trusts are being taxed without regard for the revocability of the trust.

Reasons for Exempting Intangibles

Aside from a few states which exempt *all* intangibles from property taxation, there are probably no two states which exempt precisely the same intangibles. Some states exempt bank deposits, others exempt mortgages on domestic real estate, others the intangibles of foreign corporations, and so on. Roughly speaking, there are ten states which exempt all, or the vast majority, of intangibles from all types of

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[16] *Schuylkill Trust Co.* v. *Pennsylvania* (1938) 302 U. S. 506. Real estate of the appellant was directly taxed without deduction from the share value.

[17] *Safe Deposit & Trust Co.* v. *Virginia, supra,* note 8.

[18] *Bullen* v. *State of Wisconsin* (1916) 240 U. S. 625.

[19] *Safe Deposit & Trust Co.* v. *Virginia, supra,* note 8; *Johnston* v. *State of Indiana* (1937) 8 N. E. (2) 590.

general and special property taxation, including special taxes on the income from intangibles.[20] These states are:

Arizona	Mississippi	Utah
California	New York	Washington
Delaware	North Dakota	Wisconsin
Idaho		

What are the reasons for the adoption of an exemption policy in these states? An investigation of the tax history of eight of the ten states reveals the following to have been the principal reasons:

1. To abolish a tax which has been poorly enforced and is incapable of reasonably successful enforcement. Such a tax is concentrated heavily upon a few ignorant, honest, or unfortunate persons. It lowers public morale and probably contributes to poor assessment of other property taxes.

2. To avoid the double taxation inherent in the taxation of both tangible property and representative intangible property.

3. To facilitate introduction of an income tax. While there is little reason in logic why a general income tax should not be associated with a general property tax or, conversely, why exemption of intangibles from property tax should not be accorded in states having no income tax,[21] there seems to be rather general misunderstanding on this point. State legislatures, as a matter of expediency, may find it necessary to bow to this misunderstanding, if indeed they do not share it. They may also be expected to recognize the fact that those who are hit hardest by an income tax usually benefit most from the exemption of intangibles.

4. To reduce interest rates. This argument, most fre-

[20] National Association of Assessing Officers, *Property Taxation of Intangibles,* Bulletin No. 21, May 15, 1938, p. 8; *Assessors' News Letter,* Sept. 1938, p. 3.

[21] National Industrial Conference Board, *State and Local Taxation of Property,* pp. 48–49.

quently advanced in the debtor states of the west, has been especially important as an explanation of the exemption of domestic real estate mortgages, because the incidence of a mortgage tax on the borrower has been peculiarly apparent.

5. To attract and hold wealthy residents. This seems to have been responsible for exemption of intangibles in several states in the west. Always short on capital, these states drew heavily upon the lending institutions of the east, whose holdings were exempt from taxation in the west. The intangibles which were available for taxation were few, and to tax them would have been to penalize residence in the state and discourage the influx of persons with capital available for investment. Nowadays, even the eastern states are competing for wealthy residents. We who are about to die are especially welcome, for death and taxes are not only inevitable but inseparable.

6. To avoid confiscation of all, or a large part, of the income of low-yield securities. This argument, as I shall point out later, is a somewhat specious one, but it has a strong popular appeal.

Why Tax Intangibles?

Little has been written in the way of arguments for the taxation of intangibles, perhaps because the burden of proof, at least since the middle of the nineteenth century when states began to write uniformity clauses into their constitutions, has clearly been upon the advocates of tax exemption. While more extended consideration would probably reveal minor arguments, it seems to me that there are but four major arguments for taxation of such property, each of which develops out of a separate theory of tax apportionment.

1. Intangible property ownership is an evidence of ability to pay taxes. This contention runs directly counter to the

double taxation argument which is advanced in favor of exemption. The double taxation argument is based upon the proposition that the ability of society, as a whole, to pay taxes is not affected, or at least not appreciably so, by the creation of representative intangible property. This is quite true. But the creation of such property does increase the ability of the creditor, while decreasing the ability of the debtor in like amount. If a net worth tax is impracticable, as is generally assumed to be the case, should we not tax the creditor on his credits even though we deny to the debtor any offset for his debts? Unless the real effect of a tax on the creditor is to increase the interest burden of the debtor, I think that we clearly should. A fairly strong case can be made for the theory that a tax on credits is shifted to the debtor, even though inductive proof of this proposition is all but impossible.[22] If, however, the benefits of exemption were not to accrue largely or wholly to the debtor—and in the case of outstanding securities yielding a fixed return they could not—, this is adequate reason for the contention that justice is best served by taxing intangibles.

2. The owners of intangibles receive certain benefits from government. Under the benefits theory of tax apportionment they should carry part of the tax burden. The validity of this argument seemingly hangs, as does the preceding, upon the inability of owners of intangibles to shift the tax burden, although it might be argued that debtors benefit from the protection afforded their creditors and so may properly be called upon to bear the tax shifted to them.

3. The existence of intangibles imposes costs upon gov-

[22] There are, of course, a number of studies tending to show that mortgage taxes are borne by the borrower. See Blakey, *Taxation in West Virginia,* pp. 146–147; contra, T. S. Adams, "Mortgage Taxation," *Report of the Wisconsin Tax Commission,* 1907, pp. 303–414.

ernments.[23] The multiplication of property rights has necessitated the expansion of government activities to include rather extensive regulation of security issuance and sales and of the great financial concerns, such as banks and insurance companies, which constitute the principal purchasers of intangibles. It has also added greatly to the burdens of our civil courts, which devote a substantial part of their time to the enforcement of contracts involving intangible property. While these costs amount to less, per dollar of property values, than the costs imposed upon governments by reason of the existence of tangible property, they are, in my opinion, of sufficient magnitude to justify some taxation of intangible property. It is immaterial whether the tax is shifted or not; the cost exists by reason of the existence of intangible property, and it should be borne by some one who is responsible for its existence, which may be either the debtor or the creditor or both.

4. Every self-supporting citizen should be required to contribute in the form of a direct tax for support of the government under which he lives. One of the great objections to exemption of intangibles is that such a policy exempts some very substantial citizens from payment of any direct taxes to their governments. These persons frequently exercise considerable control over government spending policies, and they should, for this reason if for no other, make some sort of direct tax contribution. This argument is not dependent upon any particular theory of tax incidence, so long as the owner of intangibles believes that he is less well off by reason of the tax than he would be were he free of it.

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[23] W. Hastings Lyon, *Principles of Taxation*, pp. 33–34.

Can Intangibles Be Discovered?

By way of rebuttal of one of the leading arguments for exemption of intangibles, I wish to point out that many intangibles can be successfully assessed. Obstacles have constantly been raised in the path of assessors who have attempted to list such property, but the situation can be remedied if the public so wishes.

If a state subjects bank deposits to taxation, the tax can easily be enforced by opening bank records to assessors or, better yet, by collecting the tax at the source. This can be done with respect both to state and to national banks. Many, though by no means all, stocks and bonds can be assessed by requiring that corporations doing business in the state provide information at the source as in Kentucky, Maryland, and Ohio, or pay the tax at the source as in Pennsylvania. Many other corporate securities can be discovered by examination of reports of the Securities and Exchange Commission and the collateral security held by financial corporations of the state. Mortgages, except in the few instances in which they remain unrecorded, can be disclosed by examining the records of registers of deeds and by reciprocal exchange of information among assessors to reach mortgages taxable outside the county in which they are recorded. If a state so desired, it could doubtless demand access to safe deposit boxes as it commonly does in the administration of death taxes. And finally, a vast amount of taxable intangibles now escaping taxation may be uncovered by examination of federal and state income tax returns.

Of course, the lowering of property tax rates on intangibles, by lessening the resistance of taxpayers to personal declarations and of the general public to enforcement measures generally, will go a long way toward improving

the listing of intangibles. Where local assessment of the tax on intangibles has been notoriously unsuccessful, a shift from local to state administration will also help. Without a decided break with tradition, such as this would represent, the subversive taxpayer habits and public attitudes which have contributed to, or developed out of, ineffective administration will doubtless remain unchanged, taxpayers will continue to file dishonest returns or none at all, and the public will resist strict enforcement for fear of losing wealthy residents to neighboring communities or for other reasons.

Principles of Exemption

Although I think that some taxation of intangibles, either on capital value or by means of a special income tax, is somewhat preferable to complete exemption, and that exemption of particular types of intangibles should be minimized, I recognize that not all intangibles available for taxation should be legally taxable, and that exemption of intangibles is more likely to spread than to contract. I have, therefore, attempted to set down some principles which may be helpful in formulating exemption policies.

Intangibles may be exempted without any obligation to exempt tangible personal property. Many authorities are of the opinion that the general property tax is gradually evolving into a real property tax. Special commissions in several states have done their part in hastening the evolutionary process by recommending the exemption of all personal property, without distinction as to its tangible or intangible character. If these commissions have been aware of the great difference between tangible personal property and intangible personal property, they have seldom given evidence of it. By adducing arguments which have bearing only upon intangibles in support of their recommendations, they

have probably badly confused the general public. As a matter of fact, the difference between tangible property and representative intangible property is as great as that between day and night, while the difference between real property and personal property is as little as that between morning and afternoon. The exemption of intangible property need not await the exemption of tangible personal property.

No distinction should be made between intangibles owned or issued by domestic corporations and those owned or issued by foreign corporations. It is readily apparent that corporate domicile in the state granting the charter is, in this day and age, a mere legal fiction. The huge corporations which are domiciled in New Jersey and Delaware by virtue of the presence of their names on a building directory and a lawyer who fills the sinecure of the corporate agent are no more residents in fact than I am.

There are several objections to the perpetuation of this fiction in the tax field. For one thing, the benefits of tax exemption are usually more fully available to large corporations than to small ones, for it is only the former which can afford to shop around for the best bargains in corporate charters. Secondly, a domestic corporation in a state such as Michigan may be handicapped in competition with foreign corporations operating in this state, the domestic corporation being taxable on all intangibles while a foreign corporation is exempt from Michigan taxes on intangibles and frequently from taxes of its state of domicile. To make matters worse, the domestic corporation, if it operates outside its state of domicile, is apt to find itself taxed on its intangibles both by its home state and by another state in which the intangibles have a business situs.

Translated into more specific terms, this recommendation means that a state should not tax its corporations on in-

tangibles used in business outside the state, since it cannot tax foreign corporations on such assets, and that, for the same reason, a state should not tax the shares of domestic corporations when owned by nonresident stockholders.

No distinction should be made between intangibles secured by property in the state and those secured by property outside the state. It is common practice for a state to exempt mortgages secured by real property within the state and tax those secured by foreign real estate. The same distinction is frequently made between the shares of corporations having all their property in the state and those having no property in the state, with partial exemption of shares in corporations whose property is partly within and partly without the state. Such distinctions are undesirable in my opinion.

The exemption of intangibles which are secured by tangible property in the state is presumably justified as a means of avoiding double taxation. Economically, if not legally, there is just as much double taxation involved in the taxation of intangibles secured by tangible property *outside* the state. Real property is taxable throughout the country; tangible personal property is taxable in all states except New York, Pennsylvania, and Delaware, and in at least the first two of these states it is reached to some extent by substitute taxes. Thus the interposition of state boundaries is of little more significance in an economic sense than the interposition of county lines within a state.

Aside from this argument of equity, there is the practical argument that it is frequently difficult to ascertain the taxability of intangibles when the location of the securing property is a determining factor. Especially is this true when a fractional part of the securing property is within the state and a corresponding fraction of the value of the intangible is exempt.

No distinction should be made between "secured" and "unsecured" intangibles. The exemption of the so-called "secured" debts while "unsecured" debts remain taxable is a common practice and one which has been fostered by several writers in the field of public finance. It is in taxing secured debts that double taxation is most obvious, especially when the security is real estate, and interest rates on such debts are lowest because risks are at a minimum. Neither of these facts supports the policy of favoring secured debts. The question of low yields as a basis for tax preference is discussed in a subsequent section leaving for consideration at this point only the double taxation argument.

The taxation of credits is nonetheless double taxation because no specific assets have been pledged to secure them. There are generally assets behind unsecured debts and these assets are generally taxable. Occasionally, of course, as in the case of personal notes, the debtor may have no assets at the time the debt is incurred. While, strictly speaking, it may not be double taxation to tax such a credit, I submit that there is no more justification for taxing it than there is for taxing a real estate mortgage.[24]

If intangibles secured by tangible property are exempt, those secured by intangible property should likewise be exempt. It is rather widely believed that a credit which is secured or backed by intangibles is so dissimilar from a credit secured or backed by tangible property as to require a different tax policy.[25] Bank stock and deposits, for example, which are backed largely by exempt intangibles, are recommended for general property taxation although ex-

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[24] I have developed the argument in my *State and Local Taxation of Banks in the United States,* Special Report of the New York State Tax Commission, 1934, pp. 76–77. It is too complicated for presentation at this time.

[25] Leland, *op. cit.,* p. 119; Lutz, "The Problem of Bank Taxation," *Bulletin of the National Tax Association,* XIII (1927–28), p. 264.

emption or preferential taxation is recommended for mortgages and most other intangibles.

If I own a house and pledge it to a mortgage company, and the mortgage company issues and sells to you a debenture, it is no less double taxation to tax your debenture and my house than it is to tax the mortgage and my house. The possible number of layers of intangibles supported by a single item of tangible property is unlimited. It is also largely immaterial. While it may be desirable to tax some layers and exempt others, the decision should have a more rational basis than that some intangibles are directly secured by tangible property, others by intangible property.

No distinction should be made between stocks and bonds. Very nearly all states grant some exemptions to corporation stock, although the exemption of corporation bonds is the exception rather than the rule. This distinction is based on the false premise that the taxation of the corporate assets and the stock is double taxation, while the taxation of the assets and the bonded debt is not double taxation. Those who divide corporate securities into blacks and whites ignore the grays of income bonds and preferred stock, but, even if we had nothing but mortgage bonds and common stock to deal with, it is doubtful whether any distinction can be drawn as to double taxation.

There is one difference between common stocks and bonds which should be considered in formulating tax policies. Bonds yield a fixed return, stocks do not. Continuity in the tax burden on bonds is thus especially desirable. They have been purchased with certain tax expectations, and changes in tax policy will cause an appreciation or depreciation which may be wholly undeserved. But this is not a reason for continuing a tax on bonds while exempting stocks; rather, assuming that stocks are exempt, it is reason for continuing a tax on outstanding bonds while exempting new

issues. I believe that such a classification of bonds would be valid under the Fourteenth Amendment and under the classification sections of most of the states which have abandoned the strict rule of uniformity.

No distinction need be made between intangibles yielding a large money income and those yielding little or no money income. It is commonly assumed that classification of intangibles should involve a whole series of categories, with high rates for those which are presumed to yield large percentage returns and low rates for those yielding little or no money income. For example, commercial bank deposits are frequently exempted from taxation or, as in Florida and Georgia, subjected to purely nominal tax rates, probably on the ground that they yield no money income. Of course, a commercial bank deposit yields an income which is just as real, if not as measurable, as the income from a savings bank deposit or a government bond. If it did not, the principle of substitution would come into play and owners of commercial bank deposits would transform them into savings deposits and government bonds. The same can be said of stocks on which no dividends are being paid. So long as they are assessed at their market value, they can bear as high a tax rate as dividend-yielding stock, for the owner can always sell them on the market and buy income-yielding securities.

This principle of substitution may be assumed to run throughout the field of intangible property, so that marginal net returns (after taxes) are equalized except as investors may demand different returns to compensate for different degrees of risk. Consequently, a security yielding a low return deserves no tax preference, and, if granted preference, its value will simply rise until the net return after taxes bears the same ratio to value as formerly. Intangibles which are exempt from taxation or which generally escape

taxation will yield a low gross return. But the fact that they yield a low gross return proves nothing about the taxes which they *should* bear.

No distinction need be made between intangibles owned by corporations and intangibles owned by individuals. Several states which tax intangibles owned by natural persons exempt intangibles owned by corporations. In New Hampshire, for example, the tax on dividend and interest income is not applicable to corporations, and in Pennsylvania most corporations are exempt on all their personal property although individuals pay taxes on most of their intangibles. While these states are willing to countenance the double taxation involved in the taxation of tangible property and one layer of intangible property, they apparently wish to avoid the multiple taxation which arises out of the pyramiding of intangibles upon a single item of tangible property. Such multiple taxation is inevitable when the intangible assets of a corporation are taxed to the corporation and the securities of the corporation are also taxed in the hands of the stock- and bondholders.

This attempt to prevent multiple taxation is not entirely successful. It is true that the pyramiding of intangibles is accomplished principally through the medium of corporations, but it may be, and to some extent is, accomplished by individuals as well. An excellent example is afforded by the purchase of securities on margin. If you buy stock on margin, your stock is left with the brokerage house (a partnership) as security for your margin account. It is then pledged by the broker to secure a loan from a bank, which loan is extended in the form of a deposit credit. The tangible assets of the corporation now secure four layers of intangibles: (1) the corporation stock, (2) the margin account, (3) the broker's loan, and (4) the bank deposit. Only one of these layers, the broker's loan, is the property

of a corporation. Thus it is clear that the taxation of the intangibles of individuals and the exemption of the intangibles of corporations does not prevent multiple taxation.

But multiple taxation can be prevented by the familiar device of debt deduction. Let each individual deduct his debts from his taxable intangibles. Let each corporation do likewise, always remembering that the capital stock is to be treated as if it were a debt of the corporation if it is to be taxed in the hands of the shareholders. Obviously, if we treat the capital stock as if it were a debt, the deduction allowed a corporation will always exceed its intangible assets; hence, we obtain the same results from the exemption of the intangible assets of the corporation. Thus, by exempting the intangibles of corporations and allowing individuals to offset debts against their intangibles, we have actually placed individuals and corporations on the same basis, and, without having avoided *double* taxation, we have at least avoided *multiple* taxation.

I am not entirely sure that we should strive to avoid multiple taxation. If intangibles are to be taxed at high rates, I would not hesitate to say that we should; but with low rates I am inclined to favor the taxation of substantially all intangibles without offset for indebtedness and without regard for whether they are owned by corporations or individuals. A low-rate tax can be defended on the ground that intangibles impose costs upon governments, and I think it can be argued that costs increase with the pyramiding of intangibles. Also, it is doubtful whether the revenue from a low-rate tax on intangibles is worth the administrative cost involved in auditing debt offsets.

The bonds of the state and its political subdivisions may be exempted although other intangibles are taxable. Up to this point I have been arguing for identical treatment of

different types of intangibles. Public securities seem to me to constitute an exception, although I do see considerable merit in the Pennsylvania public loans tax, which is collected at the source on public securities held by residents of the state.

Public securities are generally exempted on the assumption that the tax loss is compensated for by lower interest rates, with a net saving of the administrative cost of collecting the tax. When the tax is proportional, there is considerable truth in this assumption. Of course, if a state has to market part of its securities beyond its borders, the purchase price may not reflect the full advantage of tax exemption within the state. I am inclined to believe, however, that this is not a particularly important consideration for most states, especially in view of the fact that out-of-state purchases are apt to be made largely by banks, insurance companies, and trustees who are exempt from property taxes on their intangible property, and that nonresident individual purchasers probably have no intention of listing such property for taxation.

The argument that exemption of public securities diverts funds out of private industry does not impress me, especially when the exemption is from property taxes. The amount of funds invested in public securities depends upon the amount of such securities issued, and the amount of public securities issued depends very little upon interest rates. Tax exemption does permit governments to issue securities at low interest rates, but unless the interest rate is an important determinant of the amount of public borrowing there is no consequent diversion of funds.

Conclusion

It is my personal opinion that intangibles should be subject to some property tax, either on capital value or on

income. I will freely grant that this proposal lacks the logical symmetry of a proposal to exempt all intangibles, but I suspect that justice and logic are not always the congenial bedfellows that we tax theorists would make them. By this I don't mean to belittle logic and tax theory as a guide to the formulation of tax policy. I merely wish to suggest that there are a multitude of theoretical angles to each tax policy and that one theory, carried to its logical conclusion, may conflict with another. There may be no logical basis for compromise, yet a compromise may maximize tax justice. A low-rate tax on intangibles is, in my opinion, just such a compromise.

As I have indicated, I would make very few exemptions from the property tax on intangibles. I would exempt intangibles owned by resident individuals and corporations when used in business outside the state. I would exempt the shares of domestic corporations when held by nonresidents, except to the extent that the share tax is in lieu of taxes on the assets of the corporation. I would exempt the intangible assets of all banks because the federal statutes require the exemption of the personal property of *national* banks. With a high tax rate—which I do not favor—I would exempt intangibles owned by corporations and allow individuals to offset debts against taxable intangibles, but with a low rate I would allow neither exemptions nor offsets. I would exempt the bonds of the state and its political subdivisions, with the possible exception of states which market a considerable portion of their public securities outside the state. I would exempt intangibles held by such charitable, religious, and educational institutions as are granted real estate exemption, with the provision that the income be used for institutional purposes. I would have all other intangibles assessed by a state agency equipped with wide powers and ample appropriations. The policy of informa-

tion and collection at the source would be freely used. The base of the tax would be broad, and even with the low rate that would be demanded for such a tax, I think it can safely be predicted that the revenue would be substantial.

PART FIVE

EXEMPTIONS TO STIMULATE IMPROVEMENTS

CHAPTER XIII

EXEMPTION OF PUBLIC AND LIMITED-DIVIDEND HOUSING PROJECTS

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IT IS generally agreed by students and practitioners in the field of housing that, under present conditions, low-rent urban residential quarters cannot be provided by profit-seeking private enterprise. The explanation given to support this conclusion is that there is too great a discrepancy between the cost of supplying suitable dwellings and the rent level which the majority of the people can afford to pay. Estimated costs of land and building construction involve a capital outlay, the financing of which, together with taxes and operating costs, would require a minimum rental of from $10 to $14 per room in most of the larger cities in the United States.

In contrast to this, it is learned that four out of every ten non-relief families in major cities have incomes under $1500 per annum. Budget studies reveal that low-income families spend approximately 20 per cent of their earnings for shelter. Therefore, not more than $25 per month would be available for rent. For an average family of four, maximum rents would have to be from $6.25 to $8.33 per room per month. Rent actually paid in leading American cities is said to average less than $20 per apartment per month in

the lowest third of the rented dwellings. Old-law tenements in New York City rent from $5 to $6 per room on the average.

Millions of people of low income live in substandard dwelling units. Their earning levels, both now and in the near future, would not seem to constitute an effective demand for housing projects which could be supplied by private capital. Yet, the elimination of urban slums and the provision of decent, adequate housing for these unfortunates is, to an increasing extent, being demanded by the American public.

Without entering into a discussion of the merits and defects of the many plans offered for the complete solution of the housing problem, it would seem safe to say that most of them depend, in greater or lesser degree, upon government financial aid or some form of subsidy. Moreover, in view of the far-reaching social effects flowing from the provision of decent living accommodations for all classes of society, government support of a housing program is not only proper, but desirable. It must be understood, however, that such state aid is needed primarily because, on the basis of private calculation, these projects are not self-supporting. Public assistance must, therefore, be provided in the spirit of welfare and social service, and with less emphasis upon the self-liquidating character of a project or upon its possible financial returns.

Billions of dollars are needed to eradicate the slum areas and to embark upon a vast building program. Obviously, the present fiscal structure would not enable governmental bodies to provide the major proportion of these funds. The bulk of the capital must flow from private sources. Furthermore, every economy should be sought in the purchase of land, in construction costs, and in management and operation so as to bring adequate housing within the reach of

the great masses at such levels as to minimize the need for subsidies.

The Case for Tax Exemption

In order to expedite a fair amount of low-rent public housing, and to encourage private limited-dividend companies to enter the field, it is proposed that local governments should exempt part or all of the value of such projects from property taxation. An estimated value of from $1000 to $1500 per room in a housing project, would involve tax burdens of from $10 to $15 per annum for each one per cent in the property tax rate, or roughly $1 per room per month. Exemption from property taxes, therefore, makes possible a relatively large reduction in rent. It is further argued that a subsidy of this form puts a small financial burden upon the local community. Since the value of any housing project is such a trifling percentage of total assessed values in a large city, the increase in the tax rate which would be necessary to make up for this loss in tax revenue would be infinitesimal.

Moreover, this tax loss may be more imaginary than real. Before the housing project is erected, the site is usually a slum, or blighted area yielding low tax revenues or, because of delinquency, none at all. The construction of a modern building improves the neighborhood and raises the land values. Municipal expenses may even decrease because of the reduction in costs of fire and police protection, and health and sanitation services in the benefited area. This general improvement in the neighborhood frequently stimulates other new housing construction and renovation. Tax exemption is also a subsidy which is certain in amount, and which is uninfluenced from year to year by politics and pressure groups. Private builders would hesitate to invest their capital in low-rent projects that were not assured a

steady and dependable type of subsidy. Apart from these advantages, tax exemption also has the virtue of meeting the least opposition from the public. It is, therefore, politically expedient to use this form of subsidy which, since it avoids the necessity of disbursing large sums of money from the public treasury, appears to be a relatively painless method of providing public support for a deserving project.

Shortcomings of the Tax Exemption Device

Certain serious shortcomings of the tax exemption device are, however, at once apparent. It is of the nature of an indirect or hidden grant, unknown in amount, and consequently misleading. It is not a subsidy that is openly appropriated, but rather represents a loss in future revenues that must be made up by increasing other taxes. Proponents of tax exemption point out, as has been mentioned above, that it is this very feature that makes it easier to put into effect; but this would not seem to be ample justification. Concealment as a form of political strategy violates a fundamental concept of democratic government. The taxpaying public has a right to know how much it is paying and to what purpose.

While tax exemption has, perhaps, the merit of being certain in amount to the operators who undertake a given project, the fact that it is an inflexible form of subsidy and bears no necessary relationship to need should not be overlooked. The amount of the grant is measured by the size of the taxes that would otherwise be assessed against the building, the land, or both. In some instances this means that the subsidy would be too great and in others too small in terms of economic need. Where tax exemption applies to buildings only, for example, a small building on valuable land may require more aid than does a large building on cheap land; yet the subsidy would be granted in reverse

order. Furthermore, the aid, once established, is renewed automatically year after year during the period of exemption. No attempt is made to condition the amount or to readjust the subsidy as needs and costs change. Because of this situation, excess subsidies may encourage extravagances, or lead to inadequate attention to original costs. Frequently, the beneficiaries, instead of being the tenants, are the landowners, the construction and supply companies, real estate operators and management firms.

Nor is the financial burden resulting from tax exemption as light as it is sometimes said to be. Assuming the capital value of an apartment to be $4,000, complete exemption from taxes in a city like New York would involve a loss in tax revenue of about $120 per family per year. Applied to the 500,000 New York families in the lowest income groups living in substandard dwelling units, this would mean an annual cost of $60,000,000. If the principle of exemption were extended to take care of middle-class income groups in limited-dividend projects, the amount of the subsidy would naturally have to be even greater. Perhaps, in terms of social welfare, grants of this size are defensible, but it would seem rather misleading to refer to the burdens as "relatively insignificant."

It must, of course, be admitted that the new projects improve the taxable areas where they are erected and that in relinquishing potential taxes on the resulting higher values, the city is not giving up equivalent amounts of its current revenues. This leads to the conclusion that the city in reality gives up little or nothing; it simply foregoes the opportunity of collecting new taxes on higher assessed values. It should be recognized, however, that these higher values are justified only if there is a demand for the space, which is another way of saying that there is a shift in demand from somewhere else. If this shift in population

occurs within the city, values may decline in other areas; if it comes from the outside, it necessitates additional municipal services, thus increasing the need for more revenue.

In other words, the argument that tax exemption of new housing projects is virtually costless implies that there are no other causes which would have occasioned a rise in land values in these areas; that no other type of improvement would have been made; and that municipal finances are static and depend upon constant rather than increasing revenues. Moreover, it assumes that the project in question will not adversely affect other realty values.

Effect on Other Real Estate

At present, local finance throughout the country depends largely upon the general property tax and, as experience has shown, the bulk of this levy falls upon real estate. Some municipalities have supplemented this income with sales taxes, license charges, fees and other revenue measures. In the majority of cases, however, greatest reliance is placed upon property tax revenues. This means that unless and until new sources of local revenue are tapped, any form of local housing subsidy will rest primarily upon the real estate taxpayers. A subsidy through tax exemption automatically produces this effect. It reduces the tax base and, therefore, necessitates higher assessments or rates upon remaining property owners. Substantial inroads have already been made upon the local tax base in most American cities through the gradual extension of the principle of tax exemption for governmental and worthwhile private projects. Many of these municipalities are dangerously close to their tax rate limits and any large reduction in the tax base, occasioned by further extension of tax exemption, would seriously hamper them in their attempts to balance the budget.

Aside from the fiscal problem, the effect of this shift in burden from exempt to taxable property owners is to exaggerate the inequitable character of property taxation. Property owners and tenants, large and small, rich and poor alike, bear the increased tax burdens. Part of this burden is borne by needy, ill-housed families that are not fortunate enough to be living in subsidized houses. There is also a tendency toward regressive burdens upon the owners of small dwellings, thus introducing a further obstacle to home ownership. Low-income families living in their own homes, struggling to safeguard their small investments, are unable to bear part of the cost of the subsidy extended to families that may, in some instances, be in better economic circumstances. It becomes a case of "robbing Peter to pay Paul." Particularly indefensible is this type of subsidy when extended to limited-dividend projects. Rents in these housing units are usually too high for low-income groups. Middle-class families are, therefore, subsidized by public funds, while many low-income groups not receiving such aid are directly or indirectly contributing to this subsidy. Moreover, these projects sometimes draw many of their tenants from nearby privately owned apartments with the result that the returns to the sponsors of limited-dividend units may exceed those received by private taxpaying owners.

In many cities, the assessed values of one- and two-family dwellings and tenements constitute half or more of the total assessed values for tax purposes. Many owners and tenants are already in economic distress and cannot afford to carry additional tax burdens. This is partly borne out by the high degree of correlation between the percentage of tax arrears, and the percentage of small homes in an urban area. Real estate taxes do not accurately measure ability to pay. To some extent, present levies may be justified on the grounds of direct benefits received by real estate owners

for municipal services rendered. However, as population growth continues and municipal functions increase more rapidly than do the real estate values, it would seem logical to expect a shift in financial support of general social services to income taxes, and other levies the bases of which more closely approximate ability to pay. Growing demands for education, health facilities, and relief, far outstrip the growth in realty values. Therefore, cities are forced to seek large grants-in-aid, subventions, and loans from state and federal governments. Housing, as a broad welfare program requiring public subsidy, would seem to belong in the same category.

Possible Alternatives

A really adequate program of housing would necessitate public subsidies in amounts much too great to impose upon real estate owners and tenants as added burdens, especially if levied on a proportional basis. Classified or modified property taxation might be a more equitable means of spreading such burdens, but probably would not yield sufficient revenues. Increment taxation applied against rising land values is a useful supplement to local revenue, but would hardly take care of outlays for all new improvements, including rehousing projects in slum clearance programs.

The tax exemption device places the burden of raising new revenues squarely upon the local government. Moreover, it does so without clearly revealing to the local taxpayer how much it costs to provide suitable standards of housing for low-income groups. Because of its self-renewing feature it also fails to provide adequate supervision over the uses to which the subsidies are put. In the collection of public revenue, greatest emphasis should be placed upon ability to pay and, in its disbursement, the prime consideration should be social needs. If an expenditure can be justi-

fied in terms of community interest, it should be stated in a fashion which is clearly comprehensible to the taxpayers.

It would, therefore, appear desirable to provide government aid to housing in the form of direct cash subsidies based upon the principle of ability to pay, rather than through tax exemption. Revenue for this could be provided by local governments, either through new tax powers granted them by the state legislatures, or through larger shares of state-collected taxes. In addition, federal and state aid in these social services could be continued. These public grants might take the form of capital subsidies for the construction of new projects, operating subsidies for current operation, or interest subsidies on borrowed funds. The two latter devices would make possible a larger program with a given allotment of public funds; the former is more limited in its application. In all instances, government subsidies should be provided as supplements to, rather than as substitutes for, private investments. Moreover, because of the vastness of the undertakings, and consequent drain upon government resources, public aids to housing should, at least at the outset, be limited to projects designed for those classes that are in greatest need.

CHAPTER XIV

HOMESTEAD TAX EXEMPTION

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Much has been written in recent years on the subject of homestead tax exemption, especially from the theoretical viewpoint. Less is known of the actual effect of the exemption of homesteads, either as to the encouragement of home ownership or as to those readjustments of the tax system which follow the enactment of such a law.

Report of Committee on Homestead Exemption

The Committee on "Property Tax Limitation and Homestead Exemption" of the National Tax Association submitted a rather complete report on that subject to the Association in October, 1938. This report may be taken to embody the consensus of tax students on homestead exemption. I shall first attempt briefly to summarize the principal points of that report, then try to appraise the actual effect of homestead exemption in Oklahoma during the past two years, in the light of the conclusions reached by the committee.

This committee discussed the subject from several aspects. Under the heading of "Homestead Exemption and Home Ownership," the committee (1) acknowledges the general desirability of encouraging home ownership, but warns of the hazards involved in the purchase of a home

by persons whose jobs are uncertain, or whose work requires them to move occasionally from one locality to another and who as a consequence might lose their investment; (2) directs attention to the fact that the effect of such a law in causing an increase in home ownership will depend upon whether the exemption applies to state taxes only or to all taxes, state and local, and the amount of exemption and tax benefits received; (3) mentions the probability of fictitious transfers of title and other administrative difficulties; (4) points out the possibility of the exploitation of homestead exemption for speculative purposes, the aftermath of which might offset any benefits accruing to home owners; and (5) concludes that other factors such as basic economic conditions, the interest rate, home mortgage credit system, zoning and planning of community development, insecurity of income, and inequitable assessments, are probably of more importance and influence in inducing home ownership than tax exemption.

The committee then outlines four courses of action available to governments in compensating for revenues lost by reason of homestead exemption: (1) reductions in expenditures, (2) upward adjustments in assessments of taxable property or the assessment of omitted property, (3) increases in tax rates, and (4) substitution of other taxes or increased state aid. In answering the question "Is homestead exemption equitable?" the inequities attendant upon homestead exemption are treated under (1) the inequality in tax benefit between owners of low-valued homes and owners of homes of sufficiently high valuation to "use" the full amount of exemption allowed, (2) the shifting of taxes from home owners to owners of rental and business or industrial properties, many of whom may be less able to pay taxes, and (3) the inequity which inheres in the exemption of productive farm lands, but not the exemption of business

property located on homesteads in cities and towns. At this juncture the report of the committee also touches upon the lack of stimulation and incentive to the construction of farm improvements where the exemption extends to 80 or 160 acres of productive farm lands and is not restricted to farm buildings and the 5 or 10 acres upon which they are immediately located.

Finally, in its discussion of the subject, the committee declares that the taxing power should never be used to foster special privilege, that homestead exemption is a special privilege, and as such is objectionable in a democracy. Here, the point is made that politicians are likely to seize upon homestead exemption in their competition for approval of the electorate and promise to extend such exemption benefits beyond any reasonable limits, in which possibility there is great danger to local subdivisions and to home owners themselves, who of all people have a stake in the community and should be expected to insist upon a sound and stable government.

The whole subject of tax exemption is denominated a serious property tax disease, which is materially aggravated by this most recent movement to exempt so large a block of property as is represented in owner-occupied homes. The committee recommends that we move toward an exemptionless real estate tax, to which most of us, I am sure, will heartily agree. With respect to homestead tax exemption, the conclusion of the committee is summed up in the following statement:

> Our observations on trends of the movement during the past three years and our careful consideration of the thorough studies which have been completed in several states . . . support the firm conviction of the committee that homestead exemption is unsound and that the movement should be positively resisted in the interest of building sound and stable state tax systems.

Effect of Homestead Exemption in Oklahoma

Now let us analyze the effect of homestead tax exemption in my state of Oklahoma during the past two years and ascertain, if possible, to what extent the apprehensions and conclusions of the committee have been substantiated by our still rather limited experience.

Homestead exemption removed $115,177,924 of taxable real estate from the rolls in 1937 and $122,010,843 in 1938—an increase of 5.93 per cent. These sums were 9.48 per cent and 9.97 per cent, respectively, of total state valuations. This is indeed a substantial block of property, and it will doubtless continue to increase. The 1930 census shows that 225,266 families in Oklahoma owned their homes in 1930. In 1938 only 181,474 homesteads were granted exemption. (Incidentally, in our preliminary survey in 1936 to determine the probable effect of homestead exemption, we found, with the assistance of county assessors, 181,164 homesteads.) Apparently many thousands of home owners have either failed to apply for exemption or have for other reasons failed to receive it, who may gradually be expected to qualify. This possibility, together with the increase in number of home owning families which may be expected to follow the combined efforts of state and federal governments to help families achieve a status of home ownership, will tend further to enlarge this block of tax-exempt property and reduce the ability of local subdivisions to support themselves. The experience of other states will probably closely parallel that of Oklahoma in this particular.

We find the greatest percentage reduction in tax base generally occurs in areas in which the ratio of real property assessments to total valuations is high, and in which there is a high percentage of home ownership; the lowest percentage reduction in the tax base occurs in areas where

there is a high ratio of personal property and public service corporation property to total valuations, or where the average size of homesteads greatly exceeds the 160 acres to which the exemption in Oklahoma is limited. In terms of the effect upon revenues of local subdivisions it is fortunate that, generally speaking, the greatest loss is suffered in the more prosperous counties which can better afford to sustain it; conversely, the least loss is suffered in the poorer areas.

Had none of the tax been shifted to others, local subdivisions in Oklahoma would have sustained approximately the following ad valorem tax loss during the first year this law was in effect:

	Amount	Per cent of Total
County Government	$ 668,031	29.64
Cities and Towns	238,733	10.59
School Districts	1,347,151	59.77
Total	$2,253,915	100.00

Which one or combination of the four possible courses of action mentioned by the committee was taken in Oklahoma to compensate for the loss in revenue? Was there a reduction in expenditures, or an upward adjustment in assessments, or an increase in tax rates, or a substitution of revenues from other sources?

The legislature contemplated the replacement of revenues thus lost to school districts, and appropriated the sum of $1,800,000 from the General Revenue Fund for that purpose. The State Board of Education subsequently computed the ad valorem tax loss to school districts to be $1,347,151, which sum was replaced from the State General Revenue Fund (and contributed to an $8,000,000 deficit in that Fund in 1938). But despite the certainty of replacement revenues as to school districts, an examination of the

budgets of local subdivisions discloses the following shifts in ad valorem taxes levied from 1937 to 1938:

	1936–37	1937–38	Per cent of Increase or Decrease
Counties	$ 7,057,531.69	$ 7,468,505.45	5.82
Cities and Towns.	1,748,290.32	1,261,312.00	−27.85
School Districts..	15,341,952.64	16,009,288.44	4.35
Total	$24,147,774.65	$24,739,105.89	2.45

The sum of all school district levies (for all purposes excepting debt service) increased from $15,341,952.64 to $16,009,288.44, or 4.35 per cent; the ad valorem tax levies of all 77 counties increased from $7,057,531.69 to $7,468,505.45, or 5.82 per cent; the levies of all cities and towns decreased from $1,748,290.32 to $1,261,312.00, or 27.85 per cent; and the aggregate of all levies by local subdivisions for purposes other than debt service increased 2.45 per cent—from $24,147,774.65 to $24,739,105.89.

We find therefore that, on the whole, the exemption of $1,000 of the assessed value of homesteads was not followed by a reduction in ad valorem tax levies as compared to levies for the previous year; however, it may have tended to retard somewhat the upward swing of the tax levy pendulum. But although county and school district levies increased, in the aggregate, there were 22 counties and many school districts in which there was a lower tax levy in 1938 than in 1937. Likewise, although a general reduction occurred in city and town levies, there doubtless were some municipalities in which the levy was higher in 1938 than in 1937. It is impossible to eliminate all of the factors affecting the amount of tax levy to determine exactly the influence of homestead exemption. But considered as a whole, the taxes levied in 1938—the first year in which tax levies

were affected by homestead exemption—were not reduced as compared to levies for the preceding year, except as to cities and towns. The aggregate levy of cities and towns was reduced because of the greater influence of schools and county governments on our county excise boards, which boards have the power to apportion the available 15 mills between counties, cities and towns, and school districts. Municipalities ordinarily have less influence with the county excise boards, and they also have more outside sources of revenue, so for these reasons, and possibly others, when the impact of homestead exemption came in 1938, the cities and towns emerged from the scramble with a smaller share of the 15 mills than they had received in the previous year.

Naturally, this increase in tax levies computed upon a reduced tax base could only have been brought about by an increase in tax rates. The following average tax rates were levied by local subdivisions in Oklahoma for other than sinking fund purposes during the past two years:

	Rate per $100 Assessed Valuation		Per cent of Increase or Decrease
	1936–37	1937–38	
Counties	$0.58	$0.68	17.24
Cities and Towns	0.37	0.30	−18.92
School Districts	1.25	1.45	16.00
Average, All Subdivisions	$1.97	$2.24	13.71

The average county tax rate for general purposes increased from 5.8 mills to 6.8 mills; that of cities and towns was reduced from 3.7 mills to 3.0 mills; and the average school district rate was increased from 12.5 mills to 14.5 mills. The average tax rate for all subdivisions was 19.7 mills in 1936–37 and 22.4 mills in 1937–38. Preliminary examinations of budgets for 1938–39 indicate that tax levies will be still higher. With respect to school district levies,

the increase in average rates noted above may also be partially ascribed to a provision in House Bill 6 of the 1937 session stipulating that before a district could receive primary aid it must levy at least 8 mills. This requirement, which was made for the first time in 1937–38, gave a powerful incentive to many districts to increase rates sufficiently to entitle the district to share in state aid, and was responsible for some of the increase in average school district tax rates and levies in 1937–38.

Summing up, then, it can be said that homestead exemption in Oklahoma was followed by the appropriation of replacement revenues to school districts, by a reduction in the budgets of those relatively few subdivisions where tax rate limitations or action of the county excise boards prevented a corresponding increase in rates, and by a marked increase in tax rates of most counties and school districts. It appears that a majority of the school districts may have made up the homestead exemption revenue loss from other property owners, and at the expense of cities and towns, and had the state replacement revenue for lagniappe. The outstanding fact disclosed by this picture is that homestead exemption in 1938 resulted primarily in a shifting of taxes from one group of property owners to others, many of whom doubtless were less able to pay taxes than many home owners whose taxes were reduced. But it is only fair to point out that at other times and under other conditions, such as in a period of deflation when property owners are demanding economy in local government, the exemption of homesteads might be immediately followed by reduced expenditures.

As to the shifting of tax burdens between rural and urban property owners, the amount and extent of this will vary depending upon the relative number and assessed valuation of urban and rural homesteads granted exemption and the

relative volume of rural and urban real estate. In Oklahoma, for instance, 52.33 per cent of all 1938 real property valuations was of farm property and 47.67 per cent was of urban property. This is the proportion in which rural and urban real estate would have paid county taxes (and state taxes if there had been a state tax levy) had homesteads not been exempted. But following the exemption of $122,-010,843 of homestead valuations the assessed value of real property remaining subject to county taxes consisted 54.13 per cent of farm property and only 45.87 per cent of urban property. In terms of taxes levied, owners of urban real estate benefited approximately $82,000 at the expense of owners of rural real estate as a result of homestead exemption. This might be more or less, or the circumstances might be just the reverse in other states, depending upon conditions therein.

There were 114,030 urban homesteads and 67,444 rural homesteads exempted in Oklahoma in 1938. Most of the tax benefit accrued to urban home owners because of the larger number of urban homesteads and the higher tax rates in cities and towns; however, this tended to be counterbalanced by the fact that the amount of exemption "used" by rural homesteads averaged $777.69, while the average exemption "used" by urban homesteads was $610.-02. If the suggestion of the committee on homestead exemption should be adopted (that the exemption of rural homesteads be restricted to the buildings and improvements and five acres of land) the effect in Oklahoma would be to cause the shifting of a much greater portion of the county levy upon owners of non-exempt rural property, because most of the valuation of farm homesteads consists of farm lands rather than the improvements thereon; the converse of this is true in the case of urban homesteads.

The committee says: "To permit the homestead exemp-

tion to apply in the country to a large area, say 160 acres, which makes it possible for the exemption to apply to productive property and then to restrict the exemption in cities and towns to residence property only, is to legalize an unreasonable distinction, if not discrimination, between small home owners in the country and in the towns." But to do otherwise would, in Oklahoma, probably result in an even greater discrimination in favor of non-exempt urban property. For in speaking of discrimination it is necessary to think not only of the relative tax benefits accruing to rural and urban home owners themselves, but also of the consequent shifting of tax levies between those rural and urban property owners whose property remains subject to tax. And although one home owner whose home is assessed at $1,000 or more may receive a benefit of about $25, while another whose home is assessed for $250 may benefit only one-fourth as much, this should not necessarily shock the conscience, as the tax benefit may be more nearly equal in terms of their relative abilities to pay taxes. In other words, $6 or $7 may mean as much to one as $25 or $30 does to another.

An interesting aspect of this subject in Oklahoma is the reduction in assessed valuation of homesteads themselves. For the state as a whole, the $1,000 exemption amounted to 61.27 per cent of complete homestead exemption. The total assessed valuation of all 181,474 homesteads in 1938 was $199,151,539; $122,010,843, or 61.27 per cent, was exempted, leaving $77,140,696 of "homestead" property remaining subject to tax. But in 12 counties the $1,000 exemption was over 90 per cent of complete homestead exemption; and in 14 other counties it was between 80 per cent and 90 per cent of complete exemption. These counties are in the poorer agricultural areas where the average value of homesteads is low and where farm tenancy is greatest. The $1,000 exemp-

tion now provided by law apparently is sufficiently high to give complete exemption to the poorer classes of home owners, and a very substantial benefit to owners of medium valued homes. With respect to inducing tenants to become home owners in these areas, a $1,000 exemption should be as effective as an exemption of $2,500 or $5,000, for either one would amount to complete exemption. Perhaps this may help account for the fact that there has not been noticed the slightest demand for an increase in the amount of exemption in Oklahoma, as there has been in Mississippi and some other states. Or possibly the perennial dissatisfaction with conditions that exists in these submarginal areas may temporarily have found an outlet in the old-age pension movement.

Whatever may be the reason, it is a fact that there has as yet been no political agitation for an increase in the amount of exemption. Our experience in this connection runs counter to that feared by the committee on homestead exemption. Another peculiar fact is that the agitation for homestead exemption in Oklahoma came not from those areas in which the greatest percentage of families own their homes, but rather from the areas of greatest tenancy. Home owners in Oklahoma are essentially conservative and have remained so in their attitude toward taxes and indebtedness.

Does homestead tax exemption encourage home ownership and tend to cause renters to become home owners? The committee conceded that, in theory, the law should have this effect, but said that objectively the proposition was as yet incapable of being proved. Our experience thus far in Oklahoma does not enable us to go much beyond the conclusion of the committee.

We find that the number of homesteads granted exemption increased from 171,133 to 181,474, or 6.04 per cent; and that there was an increase of 2,125 in number of rural home-

steads (3.25 per cent), and an increase of 8,214 urban homesteads (7.76 per cent). The greater increase in number of urban than rural homesteads may have been due to more convenient credit arrangements in the case of urban properties, coupled with a greater financial ability to make a small down payment and the availability of homes to suit almost every purse and taste in the case of urban residents, or to other factors. Homestead exemption may have stimulated the desire, but these other factors may actually have provided the means of acquiring a home. At most, homestead exemption was merely one of several factors the combined effect of which contributed to the increases noted. There is another aspect to this matter of encouraging home-ownership which should not be overlooked, however. Tax exemption may offer something much more tangible than encouragement in those instances where families in poor circumstances are struggling to keep homes they already own.

This increase of 10,341 homesteads in 1938 was technically augmented somewhat by failure of many home owners to obtain exemption in 1937 because of failure to record their deeds prior to January 1, 1937, or because they were not actually residing on the premises on that date. On the other hand, the number of homestead exemptions in 1938 was restricted materially by reason of the failure of many owners to reapply in 1938. The number of homesteads granted exemption in 1939 should show a substantial increase after all home owners have learned the requirements of the law. As time goes on changes in the number of exemptions arising from these technical administrative causes should be held to a minimum, which will render it easier to determine the effect of homestead exemption.

To determine the exact influence of homestead exemption in bringing about an increase in number of home owners it

would probably be necessary to establish personal contact with each new home owner and ask him to analyze the extent to which he was influenced to acquire a home by reason of the fact that it would be tax exempt up to the first $1,000 of assessed value. It has not been possible to make such a study; and had it been possible, many persons thus interviewed would probably have been unable to determine the extent to which homestead exemption influenced their decision. I became a home owner myself in August of 1937, and I am not sure that I can precisely measure the extent to which I was influenced by homestead tax exemption. I do know that I should have purchased this home regardless of its exemption from taxation, because of several factors which I shall attempt to enumerate in the order of their importance: (1) a desire to establish a more permanent home in which to rear my children, (2) the inconvenience of being forced to move from a rented house whenever the owner wanted possession, (3) the convenient location of the home purchased, (4) the reasonableness of price with a low down payment, bringing the property within my means, and (5) low monthly payments, including taxes and insurance, all of which totaled considerably less than I had been paying in rent.

All of these things were of more influence than tax exemption in my case. I recall that the fact of tax exemption came to me as an afterthought, and that it brought a glow of pleasure, and a feeling of satisfaction with the decision I had already made. But notwithstanding I should have purchased this home regardless of the benefits of tax exemption (which in my case amounts to about $25 per year), I must honestly admit that I enjoy receiving the exemption and would not willingly part with it, even to avoid payment of alternative taxes which thus far have not been levied. If other home owners feel as I do about it, there is not

the slightest chance that the exemption will be repealed. At the same time I would strongly oppose any increase in the amount of exemption, which would take it out of the "storm cellar" category and aggravate its inherent inequities.

There has been very little evidence of abuse in the way of fictitious transfers of title. The penalty of six months in jail for violation of the law is prominently displayed on the application and may have deterred many persons from perjuring themselves who at other times and places would not hesitate to do so. Nor have we found the administrative difficulties insurmountable. The greatest additional burden is placed upon the assessor. Homestead tax exemption practically doubles the work of the county assessor, which we have learned should be taken into account in determining his compensation and the number of deputies provided.

Does homestead tax exemption stimulate the improvement of real estate? Perhaps not as much as the constant nagging of the housewife who wants a new bathroom or kitchen, or an extra bedroom; but it does give her an additional argument if the old house is assessed at less than $1,000, as most of them are. I have letters from several county assessors in which they explain the apparent anomaly of an increase in amount of exemptions allowed in the face of a decrease in number of homesteads, by saying that many persons improved their homes during the year thus "using" more of the $1,000 exemption allowed by law. Consequently, while we cannot say that homestead exemption has, of itself, stimulated the improvement of homesteads, we do have evidence that such improvements have contributed to the increase in amount of homestead valuations exempted in 1938.

Homestead Exemption and Indebtedness

Before closing, I want to touch upon one aspect of the subject not referred to in the report of the committee on homestead exemption, and that is the prospective effect on the indebtedness of local subdivisions.

The exemption has not been in existence sufficiently long in Oklahoma to have exerted any appreciable effect on the volume of indebtedness. The law provides that homesteads shall be exempted from levies for the retirement of indebtedness incurred subsequent to January 9, 1937. The prospective effect of such exemption on future indebtedness must remain, temporarily at least, in the realm of speculation.

The owners of homes assessed at not to exceed $1,000 all have the right to vote on bond issues which they will not be required to help retire. If relieved of this duty, is there not a likelihood that they may be inclined to vote for all bond issues submitted? Homestead tax exemption may inaugurate a period of profligacy in the voting of bond issues by creating another block of irresponsible voters who will feel little or no restraint in buying any desirable public improvement as long as someone else has to pay for it.

On the other hand, there is an ingrained disposition on the part of the people of Oklahoma, developed out of their public and private experiences, against the creation of unnecessary debt. Thus far this natural tendency has been sufficiently strong to hold the other in check. It must be admitted also that carelessness, not to say dishonesty, disclosed from time to time in the handling of public funds has more firmly cemented into the attitude of the taxpaying public this antagonism toward new bond issues, notwithstanding the availability of federal grants of assistance. The number of bond issues recently defeated in Oklahoma

on projects approved by the P. W. A. for federal participation is amazing. Many of these bond issues were defeated because of lack of confidence in the integrity of the public officials who would have had charge of the expenditure of the money. There has not been noticed as yet any mass appeal to home owners by proponents of bond issues based upon the theory that they will not have to help retire such bonds. But in a state as young and impressionable as Oklahoma anything can happen, and it is probably only a question of time until this argument will be used.[1]

It is even possible that homestead tax exemption might, on the one hand, contribute to the passage of a bond issue but, on the other hand, remove most of the taxable property wherewith to repay the bonds. While the improbability of finding a purchaser for such bonds might afford some protection to the remaining property owners, the possibility that a majority of voters, whose property is exempt, may impose a most inequitable tax load upon a minority, whose property remains taxable, presents a prospect with most serious implications for the future.

This possibility adds weight to the contention that bond issues voted for the construction of revenue-producing public utilties should be retired from income produced from such utilities, and that the dwindling residuum of property remaining on the tax rolls should not be charged with the cost of public services from which all people benefit. As the committee's report on homestead exemption puts it, "By proper legislation the purely business activities of govern-

[1] Since this was written our attention has been called to a bond issue recently voted in a school district in southern Oklahoma having an area of 10 square miles, occupied almost altogether by tenants. There are three landowners living in the district whose homesteads are exempt; the remainder of the land is owned by persons living outside the district. The three landowners whose homes are tax-exempt were reported to be the principal advocates of the bond issue. As none of the other landowners voted in the district the issue encountered little opposition.

ment can and should be entirely severed from the area of taxation."

As to possible future reductions in assessed valuations, it seems probable that, in Oklahoma at least, the increase in number of home owners in 1939, and thereafter, will more than offset normal increases in assessed valuations, leaving local subdivisions dependent upon a gradually diminishing tax base. This, in turn, will most likely bring about gradually increasing tax rates on all property remaining on the tax rolls—at least until limitations on tax rates or another taxpayers' revolt prevent further increases. If this is not to occur it will be necessary for the legislature to provide for a scientific system of assessing property for taxation, tangible and intangible, that will assure no omission of property and at the same time assure a more equitable division of the common expenses among all property owners.

It would be strange indeed if a movement having such far-reaching consequences throughout the entire state tax system as homestead tax exemption, should not be productive of some good in addition to the benefits it bestows upon home owners. It has been my observation that reform in taxation usually comes only as a last resort—that legislative bodies usually, if not always, take the line of least resistance until circumstances compel them to face the music. Homestead exemption, followed by the appropriation of replacement revenues for school districts, has been one of the factors contributing to an $8,000,000 state deficit in Oklahoma last year, and to an equal deficit this year. The state has exhausted its taxing power trying to carry the load imposed upon it by local governments. The only way out is for us to try to make local governments more self-supporting and independent of state assistance; this will necessitate the adoption of a scientific assessment procedure. Homestead tax exemption has helped bring us to

this extremity, and if, as a result, we actually get some reform in our assessment procedure, we shall feel that the question of whether or not homestead tax exemption has been worthwhile may then possibly be answered in the affirmative.

CHAPTER XV

EXEMPTION OF IMPROVEMENTS

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The subject assigned to me might be thought of as fitting into several different settings. To exempt improvements from taxation is to amputate an important element of the base of the general property tax. So would be the exemption of intangibles, of personal effects, of household goods, merchandise, and any other species of personal property. How far shall I assume that the amputation has gone, for purposes of this paper? At one extreme, one might visualize the property tax base as it now is, with all improvements exempted. At the other extreme, one might think of any or all forms of personal property as having been exempted. In fact, the status of New York State is actually of that sort. It might be argued that land, surely, would never be exempted; but in the homestead-exemption states at least partial exemption of land has accompanied the exemption of homestead improvements. The exemption of improvements in land would, in effect if not in law, leave New York State with a system of land-value taxation, while other states would find themselves with a more or less complete personal property tax, depending upon the extent that their general property tax had moved in the direction of becoming a real property tax.

TAX-BASE TINKERING

The remarks just made are intended to justify my position that the exemption of improvements is merely a case of tax-base tinkering, rather than a defense of, or an attack upon, the single tax, or land-value taxation. I know that if, as in New York State, everything has already been exempted from the ad valorem tax except real property,[1] then the further exemption of improvements will leave a system of taxation that must look like, if it does not constitute, taxation of land values, particularly if the revenue lost by the exemption of the improvements is made up by increased levies on the bare land. But I want to assume no unnecessary burdens at the outset. I know that certain proponents, and certain opponents, of the single tax think of each other as being at least queer and biased. And I know that some of the combatants on both sides must wear rhinoceros hides. Being a thin-skinned animal myself, I know that I should not survive participation in such a single-tax controversy as was staged in the pages of the *Journal of Political Economy* between Professors H. G. Brown [2] and W. I. King.[3] I want to discuss tax-base tinkering, in the form of exemption of improvements from taxation, free of any such onus as might attach to a suspicion of being for, or against, the single tax. Of course, tax-base tinkering is not entirely free from being a stench in the nostrils of some, such as those who would preserve forever what they think is the tax system of their fathers; but it is at least not likely to produce violent reaction, as is the mere thought of the single tax, communism, and leprosy.

Anyhow, tinkering with the property tax base we have

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[1] By Ch. 470, Laws of 1933.

[2] "The Single-Tax Complex of Some Economists," Vol. 32, 1924, pp. 164–90.

[3] "The Single-Tax Complex Analyzed," Vol. 32, 1924, pp. 604–12.

had always, for some three hundred years. The unchangeableness supposed to have characterized the base of the American property tax is, in law and in fact, a fiction even when it is considered over a relatively short period of a few decades. In Colonial New England the tinkering occurred in the successive revenue acts, which not only enumerated the classes of taxable property but specified the taxable unit value for each class. The pristine simplicity of society which made this mechanical procedure possible, ceased to exist in time—in most of the colonies before the Revolutionary War. The reaction provided two changes, namely the universality rule, saying that all property not specifically exempted should be taxable, to be counted and appraised by the assessor; and the uniformity rule, saying that all property so counted and appraised should be taxed uniformly as to rate throughout each taxing district. This is the essence of the American general property tax, which some naïve persons still think we have in law and in fact. We never had it in fact.

The first disturbing element was the growth of the institution of credit, and the phenomenal increase in the so-called "intangible wealth." Recognizing the unquestionable ability of the rich mortgagees to pay, but failing curiously to recognize the corresponding inability of the debt-ridden mortgagor, the legislators, courts, and administrators strove valiantly, over a period not yet definitely identified, to "enrich" the property tax base by the inclusion of this "intangible wealth," newly discovered and supposed to be fabulous in amount. We know now that the result was an almost unrelieved failure. There never was but the merest minor fraction of all this "wealth" on the tax roll; and the case of real wealth on the rolls is at least "nothing to brag about." The reaction was the familiar classification of property for taxation, by which most intangibles, and some

forms of tangibles were accorded a preferred taxable status, whereby at least the composition of the tax base was altered.

Tax-base tinkering by means of exemption of named categories of property is of course the most direct, if it has not been the most effective method. Exemptions of public property, of property used for religious, charitable, fraternal, educational, and scientific purposes, and changes in these exemptions, there have been; but public policy has not changed greatly in these matters. There have been, in certain sections, greater changes with respect to public policy on the exemption of industrial properties for encouragement. Definite efforts to exempt personal property, such as household goods and personal effects, have made little headway. The state of New York stands out as the lonely example of exemption of all kinds of personal property. And now with us is the movement for the exemption of homesteads, uncertain in its growth and unpredictable in its effects. All these are but the major movements in the tinkering with the property tax base. There is nothing new or revolutionary about it. Tinkering with the property tax base is one of the first remedies sought in any real or fancied crisis. And no element in the tax base seems secure against the tinkering.

In this tinkering experience the exemption of improvements on land as such has played only a minor part. There have been sweeping proposals of the single-taxers to eliminate all but bare land from the tax base. And, thanks to Professor Haig, we hear not only of the proposal, but also the probable effects of said proposal in 1915, to exempt improvements in New York City. And last summer there was presented to the City Council of New York a proposal for a "graded tax" on improvements whereby 90 per cent of the total amount to be raised by real estate taxation

would be derived from a tax on land values, and 10 per cent from a tax on improvements. There have doubtless been many other proposals to which less publicity has been given. All in all, the literature in the single-tax controversy is stupendous in volume and variety. There is much less critical literature on the concrete proposals to exempt improvements as such. We shall make the best use of all arguments made, regardless of source, in so far as time will permit their use.

If we were compelled to reason only from actual experience with preferential taxation, or full exemption, of improvements, the argument would be limited. For such experiments have been limited in number and in scope. In the United States only a few desultory and isolated cities have temporarily exempted improvements in full or in part, with or against the law. In the Prairie Provinces of Canada a rather more thorough and more extended demonstration has been made. While in the United States the only places where the improvements have been relatively permanently, if only partly, exempted are the cities of Pittsburgh and Scranton in Pennsylvania since 1913, the exemption is still a feature in a considerable number of municipalities in Western Canada. Of these experiences in their early stages we have heard through Professor R. M. Haig,[4] and in the later stages through other investigators. While these experiences have neither demonstrated exemption of improvements to be a panacea nor to be unworkable and valueless, they have settled certain disputed matters but have made no contributions to the settlement of certain others. These few proved facts provide, with the analysis produced incidental to the movement for land-value taxation, all the evidence there is. And with this evidence available we may

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[4] *The Exemption of Improvements from Taxation in Canada and the United States,* 1915.

now turn to ask a number of questions that should be regarded as relevant to our attitude toward the exemption of improvements.

Is the Exemption Administratively Feasible?

The principal, if not the only, administrative problem involved here is the separate appraisal of the bare land and the improvements. This is a real problem, and opponents of the single tax have made much of it, concluding that such separate appraisal is not possible, or at least not practical. On the other side, it has been argued that several states now require, as a regular assessment procedure, the separate appraisal of these two parts of real property parcels, and that separate values for each do as a matter of fact appear on the records, and the appraisal occasions little or no trouble between the assessors and the taxpayers. The very effective rejoinder to this line of reasoning is that both of these two values are taxable at the same rate, and that therefore it makes little or no difference to the taxpayer whether their ratio is accurate, so long as their sum amounts to an acceptable value for the entire parcel. This picture would no longer fit the situation when the improvements were to be given a preferential tax rate, or to be entirely exempted. It is true also that real property is customarily sold, in this country, as an entire parcel, and not the land and the improvements separately. The selling value provides therefore a basis for an aggregate assessed value of the entire parcel, but not at all, or at least not as readily, a basis for the value of either the land or the improvements separately. When entire exemption, or preferential effective rates, are accorded improvements, the portion of the value of the entire parcel at once becomes of greater significance to the taxpayer.

Nevertheless, the conclusion must be that the problem

of separate appraisal of the bare land need not stand in the way of exemption of improvements, should such exemption be otherwise regarded as desirable. This is one matter for which an appeal to the facts has some weight. The separate assessment of land for city taxes in Pittsburgh during the introduction of the so-called "graded tax" between 1913 and 1925, as well as during the period since 1925, while it has been in full operation, has somehow been made without any appreciable difficulty. At the Conference of the National Tax Association in 1929 two papers, with somewhat different views on this Pittsburgh tax, were presented,[5] one of them by the chief assessor of the city of Pittsburgh. Had there been serious difficulty in the separate appraisal of land and improvements, the chief assessor would have known about it, and undoubtedly would have mentioned it in his paper, which he did not. If it be argued, as well it may, that after all the experience of Pittsburgh is not conclusive, since the exemption of improvements applies only to the city tax levies and, even as to them, is only a 50 per cent exemption, it will be rejoined that the separate assessment of land and improvements in the Canadian Provinces has encountered no serious obstacles. What has been done can continue to be done, and doubtless be improved upon.

Is the Exemption Ethically Commendable?

It is fortunate that tax reforms are not sponsored, oftener than is the case, by a desire to make taxes or a given tax just. Not that there are not taxes and tax systems that are far from being just. But tax justice must be appraised pragmatically, and not merely from emotional or theoretical viewpoints. A tax, or a feature of a tax, is unjust because it violates some basic requirement such as the rule of

[5] Thos. C. McMahon, "Pittsburgh's Graded Tax on Buildings," and E. F. Daume, "The Graded Tax on Buildings," *Proceedings*, 1929, pp. 134–152.

economy in administration, or economy in its effects upon the distribution of wealth. And it is the violation of this more basic rule that we set about to remedy if we would make a tax just.

So it is with the exemption of improvements. Yet we are told, for example, that a tax on land is a just tax because the land is a gift of nature, not produced by human labor, and its value is a socially created product. We are told also that a tax on improvements, and tangible personal property, falling on products of human labor, is for that reason a bad tax, and unjust; and exemption of improvements should therefore be a good thing. Now, the exemption of improvements, with the concomitant increase in the taxes on land, may be a good thing—and I am rather sympathetic toward that position—but if it is a good thing, that is due basically to the economic behavior which it induces in the workers, the landlords, and the consumers, rather than to any differences in creatorship, divine in one case, and human in the other, which in itself is rather irrelevant. Of taxes, as of other things, it is true that by their whole works shall they be known.

Does the Exemption Produce Desirable Economic Consequences?

It will probably not be argued that the element of improvements on land can be withdrawn from the property tax base without producing important results. Nor will there be much dispute as to the character of these results, although there will be difference of opinion as to their extent. But much, as to the character and extent of these effects, will depend upon changes in the tax system made to compensate for the loss of revenue due to the exemption of improvements. This loss might be made up by a general retail sales tax, or by some specific tax, whose incidence

would be pretty much the same as was that of the tax on improvements. In such a case the net effect of the change would not be great, consisting mainly of a reduction in the consumption of the newly taxed articles and an increase in the consumption of improvements. The effect might be slight, and probably undesirable. But if, as is more reasonable to suppose, the loss in revenue from the exemption of improvements is to be spread over the property tax base that remains, the results will be significant, especially if land is the only remaining element.

The first obvious effect to be expected is in the incidence of the property tax. The increased tax on the land could not be shifted, and would be capitalized, as the tax-clear rental income decreased. The tax on the improvements, however, had been shifted to the tenants; improvements being exempted, the exemption would also be passed on to the tenants, ultimately, in the form of lower rents or better improvements or both. This is in substance the conclusion reached by Professor Haig, when in 1915 he tried to measure the effects of untaxing improvements in the city of New York:

> Two conclusions, however, stand forth very prominently. In the first place, the change promises ultimate benefits of considerable importance to all tenants and to many of the home owners in the outlying boroughs. These benefits, however, may be very slow of realization. Secondly, the owners of land would be charged with the costs of these benefits. These costs, in turn, would also be considerable.[6]

Two other and corollary consequences may be expected. Since the tax on land would be increased, there would be less tax-free rent, and the capital value of land would decrease; and since it is the anticipated tax-free rent that furnishes the basis for the speculation in land, there would be expected to be less speculation in land values. It should

[6] *Some Probable Effects of the Exemption of Improvements from Taxation in the City of New York,* p. 135.

then be easier, and safer, for persons of moderate means to become owners of the houses in which they live. We cannot be so sure of this result, or at least, we cannot be sure that it will not be seriously interfered with by extraneous circumstances, particularly the way in which the tax revenue lost by the exemption of improvements is apportioned or imposed upon the land. This matter will be considered below in connection with the fiscal effects of the exemption. But if the exemption of improvements proves to have the effect of lessening speculation in land, and of stabilizing land values, that would be all to the good.

Another result to be expected is the more economical use of land. It will be more costly to hold land out of use, or to devote it to an inferior use. For the rental value of the land will tend to be determined by the value of the highest use to which land might be put, and the added tax on the land will vary with the rental value, presumably. The savings in taxes resulting from the exemption of improvements will be greatest where the parcel is most highly improved, and least where there are no improvements at all. There is, however, ground for an uneasy feeling that in this analysis some of the retarding or offsetting factors have not been duly considered. But in so far as the result proves to be a more economical use of land, the effect is material, and beneficent.

How Will the Exemption Affect the Use of Property as a Base for Taxes?

It is of major importance to inquire how the exemption of improvements will affect the diminished tax base in its use as a base for the tax load necessary for the public treasuries dependent upon this source of revenue. For it is to be assumed that the needs of the treasuries are the same after as before the exemption of the improvements. And it is

simple to assume that the revenue lost by the exemption will be made up by an increase in the load on the property that remains taxable, although there are other ways to make up the loss. Will, then, the remaining property tax base, after the exemption of improvements, in every locality and during good times and bad, be adequate to carry the undiminished load? Upon that point, the experiences of the Canadian cities have yielded some evidence, and it is not particularly favorable to the exemption of improvements.

The significant facts relative to the exemption of improvements in western Canada, for my purposes, are four or possibly five in number. I have not been able to undertake the gathering of these facts myself, of course. The few figures I shall cite as significant I have taken from an article from the pen of Mabel Newcomer and Ruth G. Hutchinson.[7] It is proper to say that these two writers relied heavily upon an earlier basic study made by Professor R. M. Haig,[8] as well as upon other sources too numerous for me to recite here.

Fact number one is indicated in the following sentences from Newcomer and Hutchinson, at page 367: "The exemption of improvements from local taxes in the western provinces grew steadily for some twenty years, reaching a peak about 1913 or 1914. This was a period of rapid settlement in the region. Building may have been stimulated by the promise of tax exemption; but in any case land values increased in spite of rising land taxes. . . . The movement was checked by the decline in land values accompanying the business depression of 1913." Since then few provisions for exemption have been made and in some cases exemptions have been removed. The form of exemption, when

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[7] "Taxation of Land Values in Canada," *Journal of Political Economy*, 1932, Vol. XL, pp. 366–78.

[8] Particularly *Exemption of Improvements from Taxation in Canada and the United States*, 1915.

not 100 per cent of the value of the improvements, is taxation of improvements at some fraction of full value, such as one-fourth, one-half, or two-thirds, land being assessable and taxable at full value.

Fact number two is the heavy shrinkage in land values, following the 1913 depression, while the value of improvements either showed moderate decreases or even in most cases rose. Say Newcomer and Hutchinson: "Land values decreased 56 per cent in Victoria between 1915 and 1922, whereas improvements decreased only 5 per cent in value during the same period. . . . In Calgary land values shrank 45 per cent in the four years 1914-18. The value of improvements rose 9 per cent during the same period." These are characteristic movements of land and improvement values in western Canadian municipalities since 1913.

Fact number three is the increase in the tax rate on property, consisting chiefly of land, during the years following 1913. Of this increase there are undoubtedly two principal causes: First, the nearly, if not fully, universal tendency to increase local governmental expenditures; and second, the narrowed tax base. In any case, the tax rate in Edmonton, Alberta, rose from 1.75 per cent in 1914 to 4.75 per cent in 1930. It rose in Calgary from 2.075 to 4.60 during the same period. In Victoria, B. C., from 2.235 to 3.64. From 1914 to 1929 it rose in Moose Jaw from 1.755 to 4.87. And so the figures run for other cities.

Fact number four is the increase in tax delinquency which paralleled the increase in the tax rates, and accompanied the shrinking of the land values. "In the city of Edmonton arrears outstanding increased from $2,360,000 in 1914 to $6,775,760 in 1918. . . . Calgary showed an increase in the tax arrears from $527,544 in 1913 to $4,539,718 in 1918. . . . Tax arrears in Victoria in 1918 amounted to nearly three

times the tax levy for the year." There are similarly dismal data for other cities in these provinces.

As a possibly significant fact number five, and in any case as a conclusion of an attempt to establish a causal relationship between the exemption of improvements and the aforementioned unpleasant tax facts, I cite the following statements by Professor Haig,[9] relating to the cities of Saskatchewan: "Such data as are available tend to show that land values form the least stable portion of the tax bases, and that those cities which have depended upon land most heavily are those which have had the greatest difficulty in collecting taxes."

There is no reason for doubting the correctness of Professor Haig's conclusion. Given the particular Canadian situation, what happened in the way of shrinking land values, rising tax rates, and mounting delinquency of tax payments is exactly what one could have predicted, what one should have expected. Whatever a business depression may be, one of its principal effects is to decrease rental values. The reduced rentals, projected indefinitely into the future, produce a reduced capital or market value. Because public expenditures do not necessarily, or even probably, shrink during the depression, the tax rates on the diminished tax base must be raised in order to yield the amount required. These higher rates on the diminished base produce a downward spiral of devaluation of the still taxable land. And this effect is intensified by the fact that only a part of the taxes levied is collected. For many landowners and speculators find themselves unable or unwilling to pay the tax. Borrowing by the municipalities takes place, and soon a large part of the collections must be used to pay

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[9] "Limited Single Tax," *Proceedings* of the National Tax Association, 1917, p. 377.

debts incurred to cover previous deficiencies met by borrowing.

Improvements, as well as personal property, do not bear taxes, or are taxed at preferential effective rates. Their value is therefore depressed less by taxes than is the value of land, if it is depressed at all. Anyhow, such taxes as are levied on the improvements are largely shifted to the tenants, and hence do not affect the value of the improvements. Moreover, the value of improvements must be largely determined by their cost of production; while it is not true that the value of land is anchored to its cost of production, since it has no such cost. Therefore there must be a tendency for the greater part of the fluctuations in the value of real property to be absorbed by the landlord as distinct from the owner of the improvements. And this will be true also, if only to a lesser extent, if improvements remain fully taxable. The value of land is inevitably the least stable element in the property tax base. The landlord does not enjoy this burden; and the public treasuries cannot be expected to be pleased or well served with the recurring delinquencies.

Conclusions

Shall we then recommend that improvements be exempted from property taxation? On purely economic grounds some good reasons can be given for such action, the principal one of which is the stimulus given to building. On purely fiscal grounds, however, the answer must be negative. So long as the general property tax is used as a "deficiency tax," to raise whatever amounts are needed and not forthcoming from other sources, something can be said for a broad tax base. To concentrate the tax on the land tends to make the land values even more unstable than

they would otherwise be, and thereby tends to multiply delinquencies and other difficulties for local public treasuries.

As long as the proposal is one of tinkering with the tax base, and not a movement for the establishment of a system of land value taxation, it is not unimportant in which sequence the disintegration of the property tax proceeds. A strong argument can be developed for the elimination of intangibles, because, first, their inclusion involves multiple taxation, and, second, they cannot in practice be taxed anyway. Likewise, most forms of tangible personal property ought to be withdrawn from the list of taxables before improvements are withdrawn. Improvements and tangible personalty have much in common; but I think they differ from each other significantly in the ease with which they can be locally administered. Almost all forms of tangible personalty can get away from the tax collector; improvements much less readily. In other words, improvements should be retained as a part of the property tax base as long as any other item except bare land is retained.

In the case of New York State, where the tax base has been narrowed down to real property, or as other states shall reach a similar condition, serious thought might well be given to the possibility of exempting improvements, possibly somewhat according to the pattern recently proposed for New York City. But this serious thought should, among other things, deal with the problem disclosed in the experience of the municipalities of western Canada, of determining how much of the economic rent to take annually in taxes. The Canadian cities have taken, or tried to take, whatever revenue they needed, usually a fairly constantly growing amount, from an economic rent that varied with the business cycle, leaving widely varying amounts for retention by the landlords. The variable and uncertain magnitude of this tax-free rent must render the ownership of

land very unstable and perhaps even more speculative than it otherwise would be, whatever we may think of the fairness of making the landlords economic buffers between the business cycle and the steady and stable needs of the public treasuries. For the overcoming of this particular difficulty it would seem better to take from the landlord a fairly constant portion of the aggregate rent, and to let the municipalities find elastic sources of revenue elsewhere, say in other taxes, possibly state administered. A conscientious consideration of this fiscal problem will probably delay the exemption of improvements for a long time to come.

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